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The next stage of ESG evolution in the pension landscape

Trust must be earned

Amundi ASSET MANAGEMENT

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Foreword

This report marks the tenth anniversary of the Amundi/CREATE-Research annual global survey of pension investors. The series has addressed the key issues that these investors face as they seek to meet the retirement needs of millions of people in the key pension markets around the world.

This year's survey has focused on how ESG investing is likely to evolve after the exceptional events in 2022 described in the report. The resulting underperformance is seen as a temporary setback, not an irreversible trend. The majority of survey respondents continue to see ESG investing as central to long-term value creation in this era of global warming and social inequality.

Hitherto, there have been problems on the transparency and data side. Demand for ESG investing has run well ahead of regulators' capacity to create the necessary standards and reporting frameworks. This has been changing with a raft of new regulatory and policy initiatives announced in 2022-23 in China, Europe, India, Japan and North America. They seek to improve transparency across the ESG value chain and enable capital markets to price in ESG risks and opportunities.

For their part, pension investors are also expanding the list of criteria used in the manager selection process for ESG mandates, making them more robust and demanding. There has been a discernible shift from quantity to quality.

As a result, the report concludes that a more robust version of ESG investing is coming into view with a strong focus on real world outcomes and accountabilities. This shift marks a defining moment in the next stage of ESG evolution.

We would like to thank Amin Rajan for providing an impartial assessment and also for the productive collaboration between Amundi and CREATE-Research over the past ten years.

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Acknowledgements

"As climate change intensifies, natural disasters and warming temperatures could lead to declines in asset values that could cascade through the financial system. And a delayed and disorderly transition to a net-zero economy could lead to shocks to the financial system as well."

Janet Yellen, US Treasury Secretary

This survey marks the tenth anniversary of the annual series jointly started by Amundi and CREATE. This year's survey aims to assess the future of ESG investing following its recent travails.

They have forced introspection amongst the global pension community, while duly taking account of Janet Yellen's assessment.

My foremost thanks go to 158 pension plans in Asia-Pacific, North America and Europe who participated in the research on which this survey is based.

Many of them have been our regular contributors and have, over time, helped to create an impartial research platform that is now widely used in most pension markets.

Special thanks go to IPE for helping to conduct the survey and to its editor Liam Kennedy for his support and collaboration since this series began.

I couldn't let this anniversary pass without expressing sincere gratitude to Amundi for sponsoring the publication of the surveys over the years, without influencing their findings in any way. Their arms-length support has lent an extra dimension of credibility and impartiality to our work.

Last but not least, I would like to thank various colleagues at CREATE for helping to deliver this year's survey: Anna Godden for desk work, Lisa Terrett for survey management, Naz Rajan for data analysis and Dr Elizabeth Goodhew for editorial support.

If, after all the help I have received, there are errors or omissions in the report, I am solely responsible.

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Contents

Foreword i

Acknowledgements ii

1 Executive Summary **1**

Introduction and aims 2
Survey highlights 3
Four key findings 4
Theme 1 From virtue signalling to value signalling 7
Theme 2 'Trust but verify' is the new mantra 8
Theme 3 ESG pillars are attracting a critical mass of assets 9
Theme 4 ESG investing is entering a more demanding phase 10
Theme 5 Inherent trade-offs are adding to complexity 11
Theme 6 Growth has outpaced capacity creation 12

2 The rise of purposive capitalism **13**
What is new, what is different?

Overview 14
Key findings 14
The ecosystem of capital markets is changing 15
Net Zero marks the second era of climate finance 17
Developed markets have a head start in ESG initiatives 19

3 Blockers and drivers **21**
What has hindered ESG investing and how will that change?

Overview 22
Key findings 22
ESG has experienced headwinds recently 23
Issues around definitions have caused a setback for SFDR 25
Regulators and policymakers are driving the ESG agenda 27

4 A rubric for progress **29**
Where is the advance most evident?

Overview 30
Key findings 30
ESG will ride the current thematic investing wave 31
Impact investing is at an early stage 33
ESG mandates demand more from asset managers 35

1 Executive Summary

Introduction and aims

A juggernaut that's losing momentum or just refiring its engine?

This question on ESG investing has come to the fore due to a confluence of exceptional events in 2022.

After meeting investors' return expectations since the 2015 Paris Agreement, last year's savage bear market hit a broad range of investment strategies, no matter their intrinsic merits. ESG was no exception.

The episode showed that ESG investments are exposed to periodic setbacks due to a larger dynamic that has little to do with ESG per se.

The fact remains that ESG investing has successfully challenged all long-held paradigms centred on financial factors to the exclusion of environmental, social and governance factors. These are now seen as vital in tackling a whole host of negative externalities that directly impact on corporate profitability.

"The ESG pillars have never been so central to the investment conversation."

An interview quote

While 2022 will be remembered for rising global inflation and the Russian invasion of Ukraine that roiled capital markets, the year is also noted for major progress on regulatory and policy fronts in key markets like America, China, Europe and Japan.

These have served to create fresh tailwinds behind ESG investing by improving the data architecture via mandatory reporting of ESG data and accelerating the transition towards green energy.

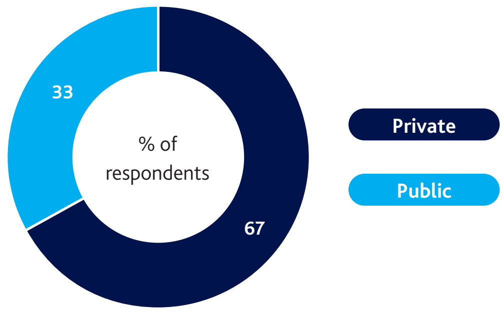
They have also served to confirm the widely held belief that investors continue to remain in the midst of one of the biggest secular shifts in living memory, propelled by a strengthening consensus to address global warming and social inequality.

Pension plans worldwide have been amongst the biggest ESG investors. It is time for a stocktake on how they now see the future. Hence, the 2023 Amundi–CREATE Pension Survey pursues four broad questions:

- What is the current state of play in light of 2022 events?
- What are the recent blockers and future drivers of ESG investing?
- How will ESG investing evolve over the three next years?
- Why is external manager selection set to change radically?

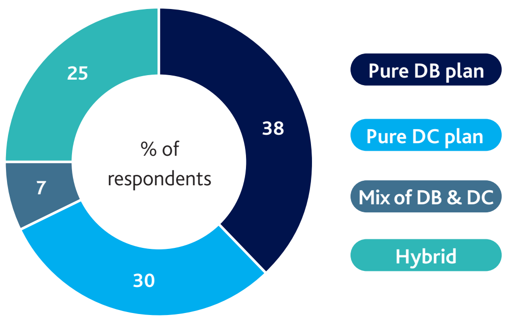
These questions were pursued in a survey of 158 pension plans in Asia-Pacific, Europe and North America, with a combined assets under management of €1.91 trillion. Their details are given in the charts below. The survey was followed up by structured interviews with key decision makers in 30 responding organisations. The survey provided the breadth and the interviews the depth and insights. The rest of this section provides the survey highlights, its key findings and the themes that support them.

What sector does your pension plan cover?



Source: Amundi Asset Management / CREATE-Research Survey 2023

What is the nature of your plan?



Source: Amundi Asset Management / CREATE-Research Survey 2023

Survey highlights

(% of survey respondents)

Current state of play

26%
Have already implemented ESG strategies and a further 55% are in the process of doing so

18%
Have already implemented a net zero strategy and a further 43% are in the process of doing so

57%
Seek to mitigate all ESG-related risks

53%
Aim to enhance risk-adjusted returns from ESG-related opportunities

Blockers hindering progress recently and drivers fuelling future growth

63%
Suffered ill-timed sector bets during the 2022 bear market, harming performance of ESG investments

56%
Think the political backlash against ESG in the US is unnerving pension investors

61%
Think new regulatory progress on data disclosures will weaken barriers to growth in ESG assets

59%
Believe recent policy initiatives in America, China and Europe will speed up the pricing in of ESG risks

Evolution over the next three years

53%
Expect the share of ESG investing in their active portfolio to rise

49%
Expect the share of ESG investing in their passive portfolio to rise

63%
Favour climate change as their main environmental theme

64%
Favour diversity and inclusion as their main social theme

Manager selection criteria

67%
Require their external asset managers to have a good track record on delivering their clients' ESG goals

65%
Require their external asset managers to have a good track record on stewardship and proxy voting

58%
Require a value-for-money fee structure

56%
Require core ESG values to be embedded in their managers' corporate culture

Four key findings

1. There is a distinct shift from quantity to quality after the market rout of 2022

ESG investing has been advancing into pension portfolios. In the current adoption cycle, more than four in every five survey respondents are either now implementing ESG factors or have already embedded them into their portfolios. Nearly seven out of ten have either embraced the net zero emission goal or are now doing so.

In the process, one in every two survey respondents expect to enhance risk-adjusted returns from ESG-related opportunities.

"The market crash was the 'Archduke Ferdinand' moment: the catalyst for big change in the way ESG products are built and sold."

An interview quote

This advance has been led by three approaches: stewardship and proxy voting, best in class companies and ESG integration in the investment process.

After headlong growth in assets that delivered decent returns, pension plans faced a moment of reckoning in the bear market of 2022, sparked by a combination of steep prolonged interest rate hikes and the energy crisis provoked by the Ukraine war.

ESG investing suffered in the resulting generalised market falls, reminding investors that it is not an all-weather strategy, nor is it wise to have expectations that are unfeasibly high. It will be marked by periodic setbacks due to a larger dynamic that has little to do with ESG investing *per se*. It will be prone to reversals from time to time, but with a long-term symmetrical pay-off (Figure A). By implication, 79% believe that ESG investing does not hurt performance in the long term.

But, more immediately, the war in Ukraine has starkly exposed the trade-off between energy security and the net zero goal, and between not investing in companies producing controversial weapons and helping Ukraine fight Russian aggression.

Thus, the burden of proof that ESG investing works has intensified exponentially for asset managers, as pension plans demand ever more transparency around the investment process, a laser sharp focus on ESG outcomes and timely accurate reporting. 'Trust but verify' is the new mantra.

More details in Themes 1 & 2

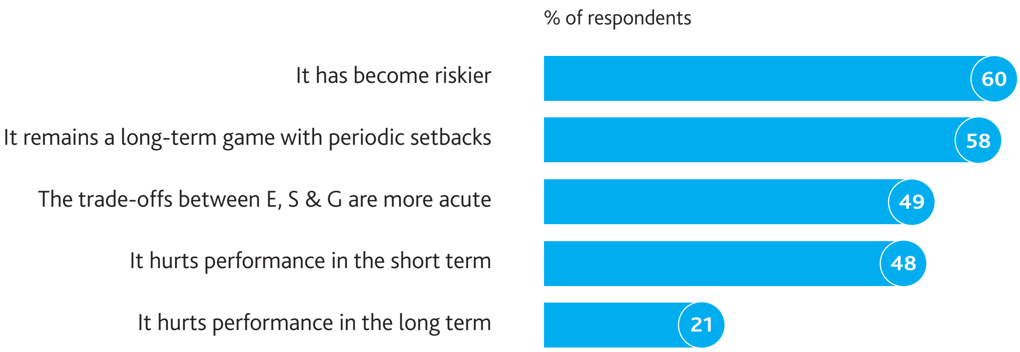
2. After a slow start, recent progress on the regulatory and policy front augurs well for future growth

Last year also brought a raft of long-awaited policy initiatives to tackle factors that had long conspired against investor interests – especially the absence of credible audited data on ESG risks, opportunities and outcomes.

The sudden collapse of Silicon Valley Bank, which had a top ESG rating, was a timely reminder that data has been the Wild West of ESG investing. Governance lapses had long gone undetected.

Hitherto, regulatory progress on mandatory disclosures of data as well as clearly defined standards of measurement and performance have been patchy: not robust enough to be decision-useful for investors.

Figure A **After its adverse performance in 2022, how do you now view ESG investing?**



Source: Amundi Asset Management / CREATE-Research Survey 2023

The resulting confusion provided further ammunition for the political backlash against ESG investing in the US, unnerving investors and their asset managers alike. As a result, capital markets have been slow to price in ESG risks and opportunities until they are clear about how policymakers will create the required incentives and sanctions.

In that context, the positive winds of change are now evident. In 2023, China, Europe and North America are all now introducing new regulatory proposals on data disclosure by listed companies. Data providers are also providing forward-looking measures of decarbonisation to complement historical data.

"More than ever, pension plans want to be assured that a green portfolio equates to a green planet."

An interview quote

For their part, key governments have been implementing ambitious initiatives on the climate front; namely, the Inflation Reduction Act in the US, the 'Fit for 55' programme in the EU, China's rise as the largest investor in climate transition technologies, Japan's adoption of its Green Transformation (GX) plan, and Australia's plan to leverage private capital in green infrastructure projects.

The interests of business and society are now more intertwined than ever.

More details in Themes 1 & 2

3. ESG investing will continue to deepen its roots in the pension landscape

The advance of ESG investing will likely continue into core pension portfolios. Now, it has a share of over 20% of actively managed portfolios among 38% of our survey respondents. The parallel figure for passively managed portfolios is 34%. Developed market assets predominate in both cases.

As a cohort, emerging market companies lag behind their developed market peers in ESG ratings, with wide gaps in every ESG pillar. But gaps are set to narrow as America and Europe seek to use carbon border adjustment taxes to protect domestic industries against the regulatory arbitrage that promotes the relocation of their production base.

Thus, our survey respondents' ESG allocations are set to increase in each of the three pillars (Figure B). Just as important, ESG factors are now increasingly featuring in the top-down strategic asset allocation of pension plans, similar to other long-established risk factors like inflation, GDP and interest rates. The advantage of being part of SAA with its own policy benchmark is that ESG investing is no longer constrained by the traditional cap-weighted benchmarking framework.

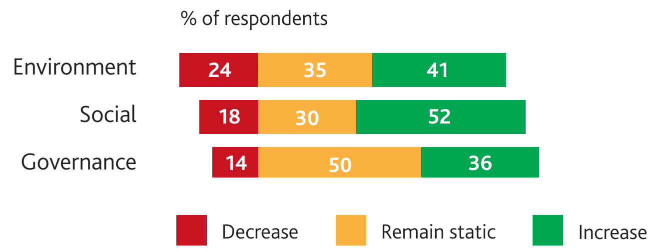
There are, however, two reasons why growth will be slower than in the recent past.

First, populism in key Western economies risks slowing down the green transition, since climate action versus voters' wallets has become a defining political hot potato. This is all too evident from recent policy backpedalling in France, Germany and the UK. The cost of living crisis sparked by steep increases in energy prices has pushed energy affordability and security to the top of the policy agenda.

Second, the 2022 market debacle has changed the growth dynamic by exposing the limitations of the prevailing ESG model in the new market regime of low real returns. In it, ESG pledges may well prove harder to deliver, especially in an era of increased accountability.

More details in Themes 3, 4 & 5

Figure B **How are allocations to the three ESGs pillars likely to change over the next three years?**



Source: Amundi Asset Management / CREATE-Research Survey 2023

4. External manager selection criteria are far more stringent

The focus on accountability is evident in the criteria now used for selecting asset managers for ESG mandates. The criteria fall into two groups.

The first covers qualifiers. As the name implies, it includes those investment basics that managers need to get right to have baseline credibility. They include an alignment between core ESG values and the corporate culture of the asset manager, a value-for-money fee structure, customised reporting and good technological capability to harness and analyse data. Notably, though, these criteria are necessary but not sufficient to earn a mandate.

The second group covers differentiators. They give managers a compelling edge over their competitors in the selection process.

"Fuzzy ESG that brought together confusing ideas is dead. A more robust version is coming into view."

An interview quote

A proven track record in stewardship and proxy voting that delivers clients' ESG goals is near the top of the list and gives asset managers the power to influence the ESG agenda of their portfolio companies and monitor outcomes. In the absence of reliable data, it is also seen as a key tool to observe the nature and impact of a company's ESG policies on practical outcomes.

This applies to passive funds as well as active funds. After all, passives are forced holders of shares in the chosen indices: they cannot divest poorly performing shares. They are the ultimate long-term investors who can only improve the quality of their beta assets via stewardship and proxy voting.

Other differentiators include: a broad talent pool well versed with the complexity of managing various interrelationships in the ESG value chain and widely admired thought leadership that provides actionable insights combined with proven capabilities in thematic investing and ESG advisory services.

These more demanding sets of selection criteria have created capacity shortages: growth in ESG investing has been exponential while the creation of the required infrastructure of skills and data has been, at best, linear. Only 8% of asset managers are now rated as excellent, with a further 22% rated good, by our survey respondents. The remaining 70% are rated fair or poor. The gap reflects perceptions of widespread greenwashing that has invited intense regulatory scrutiny on both sides of the Atlantic.

That there are excellent or good asset managers already out there at this stage of ESG evolution is yet another indication that ESG investing is coming of age, with a high likelihood of merging with fundamental investing by the end of this decade.

Finally, the Covid-19 pandemic and climate action share a common narrative – one of human persistence in the face of acute adversity. Together, over time, they will serve to enhance the ESG brand, not weaken it.

More details in Theme 6

Theme 1 From virtue signalling to value signalling

Old-style socially responsible investing has now morphed into ESG investing that targets financial as well as social and environmental goals. That this ambitious version has been advancing into pension portfolios is clear from the current state of the traditional four-stage adoption cycle (Figure 1.1, left chart). Nearly four in every five survey participants either already have a mature portfolio (26%) or are in the implementation phase (55%). The rest are either close to decision making (16%) or at the awareness-raising stage (3%).

ESG in general and climate transition in particular are thus set to be compensated risk factors.

As Figure 2.1 in Section 2 shows, for at least one in every two participants, this advance has been led by three approaches: stewardship and proxy voting; best-in-class companies with high or improving ESG scores; and the integration of ESG factors in the investment process.

In turn, these approaches have mostly relied on bottom-up security selection; the top-down asset allocation approach is evolving slowly, while data for the requisite modelling remain sparse.

Geographically, the advance is led by pension plans in Europe, followed by North America and then Asia Pacific. Differences in regulation and national cultures have been the key drivers.

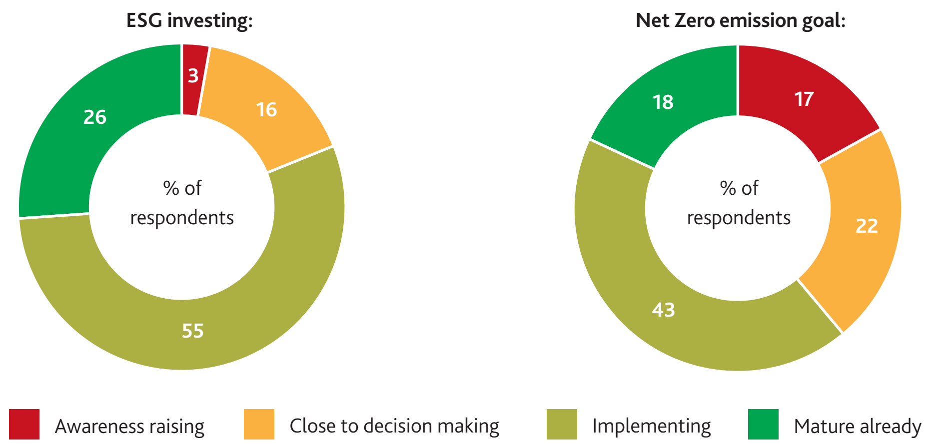
This is also partly mirrored in the adoption of the net zero goal, as envisaged by the 2015 Paris Agreement (Figure 1.1, right chart). Around 40% of our survey participants are still at the awareness-raising and decision-making phases, and the majority have already adopted the goal as part of a major reset first inspired by the Glasgow COP26 in 2021 and its successors in 2022 and 2023.

Among those who have adopted the net zero goal, 23% already have an overt strategy for achieving the goal and 28% report work in progress (see Figure 2.2 in Section 2). This is in the knowledge that climate change is already profoundly changing our physical world.

The World Meteorological Organisation now predicts a 66% likelihood that global average temperatures will exceed their pre-industrial levels by 1.5°C in at least one of the next five years.

Last year, the odds of that happening between 2022 and 2026 were 48%; in 2015 they were zero. ESG in general and climate transition in particular are thus set to be compensated risk factors. This serves to explain why the majority of our survey respondents have made progress towards both ESG investing in general and the net zero goal in particular.

Figure 1.1 In which stage is your pension plan currently with respect to ESG investing and your net zero climate goal?



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"ESG investing is just investing. It's all about risk and return but in a wider societal context."

"Reinventing a century-and-a-half-old global energy system in just 25 years is an epic task."

Theme 2 'Trust but verify' is the new mantra

ESG is not equated to concessionary or philanthropic finance.

A distinctive feature of the evolution from socially responsible investing to ESG investing is dual emphasis – making money while making a difference for wider society via a transparent investment approach that assesses the positive and negative impacts of corporate actions affecting businesses, people and the planet.

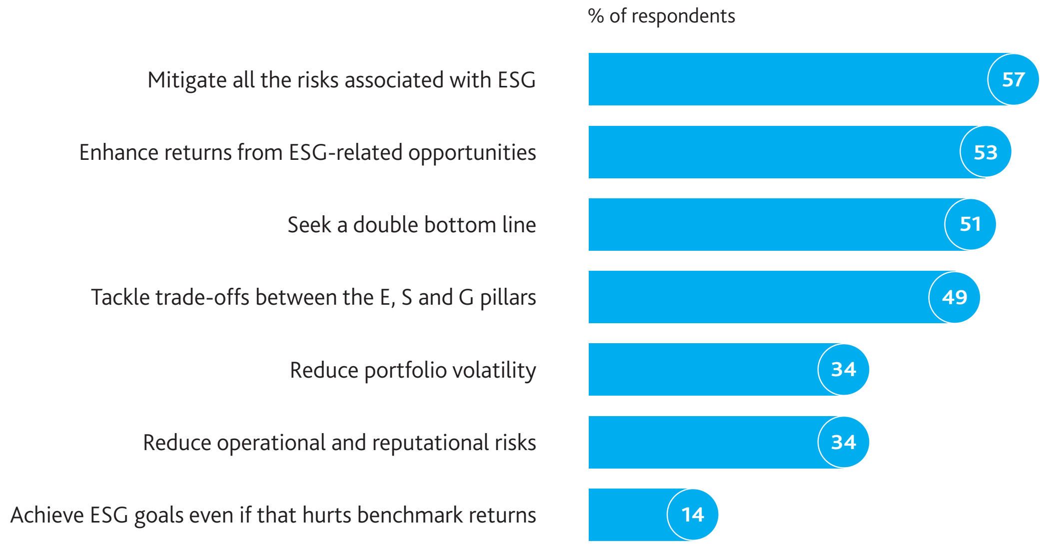
As yet, there is no robust system to assess the value created or destroyed by the use or misuse of ESG capital. But a new language and mental models are evolving, as are various indicators that act as guideposts in the investment process. This is indirectly reflected in two sets of mutually supportive goals that are being pursued currently (Figure 1.2).

The first set is about investment basics: minimising risks linked with ESG factors (57%), enhancing returns from related opportunities (53%), seeking double bottom line benefits via societal and environmental as well as financial returns (51%), and reducing portfolio volatility (34%). Notably, only 14% are prepared to achieve ESG goals at the expense of portfolio returns. Many among them have good funding status and seem content with acceptable absolute returns that may fall short of benchmarks from time to time. ESG is not equated to concessionary or philanthropic finance. Rather, it is a hard-nosed approach to investing that aims to benefit from climate change and societal upheavals.

The other set is about secondary issues, such as tackling trade-offs between the E, S and G pillars (49%) and reducing operational and reputational risks (34%). In pursuing these goals, pension plans are taking nothing for granted, as was the case before the 2022 bear market.

Now, they are demanding to know the thinking that goes into different elements of the ESG value chain, including the integration process, risk modelling, securities selection and regulatory compliance. They are also demanding robust independently audited impact metrics. More than ever, they are keener to see evidence that their ESG investments make a difference.

Figure 1.2 **Which goals are being targeted by ESG integration in your portfolio, currently and over the next three years?**



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"High scoring ESG firms also exhibit higher profitability, stronger balance sheets and higher resilience in times of market stress."

"We want to see clear evidence that our ESG investments do well financially and do good socially."

Theme 3 ESG pillars are attracting a critical mass of assets

It is clear that ESG investing is taking root in the pension landscape (Figure 1.3). Its share of active portfolios is currently over 20% for 38% of our survey respondents. The corresponding figure for passive portfolio is 34%. At the other extreme, 19% of respondents have zero allocations to either portfolio.

These numbers reveal a foundational trend that had been evolving since the 2015 Paris Agreement and was accelerated by Covid-19. The latter exposed the importance of biodiversity, supply chain management, workforce relations, human rights and racial inequalities. Stakeholder capitalism is on the rise. It has even been embraced by the influential US Business Roundtable.

Clearly, the rise of ESG investing has come with some pain points.

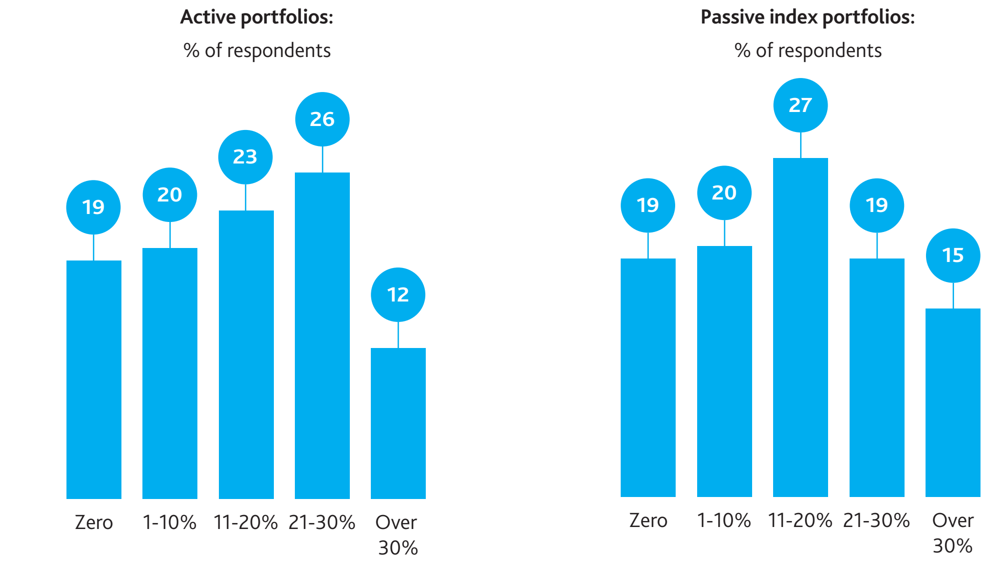
There are other reasons why ESG investing has gained traction. To start with, it complements traditional modern portfolio theory by reinforcing the role of cardinal concepts like risk and return. Furthermore, it offers deeper insights into the value creation process in a world where negative externalities, if left unchecked, could wreak havoc with corporate profitability. Finally, it is in line with the emerging value systems that strive for a planet that is fit for human habitation and societies where no one is left behind.

Of course, progress in these and other related areas has been piecemeal, as governments perform a delicate balancing act between competing priorities in the wake of the pandemic and the Ukraine war. To complicate matters, the political backlash against ESG in the US has put American pension plans in a real quandary. Mobilising capital at scale is difficult while regulators deliberate.

In addition, as Figure 3.1 in Section 3 shows, the lack of mandatory disclosure of ESG risks by listed companies until relatively recently has prevented capital markets from pricing them fully. Worse still, the lack of consistency in data from different vendors about the same companies has sent out inconsistent market signals.

Where supportive legislation has been introduced – like the European Union's Sustainable Finance Disclosure Regulation (SFDR) – doubts persist as to whether it will tackle greenwashing or drown aspiring investors and companies in the muddy waters of complex rules. Clearly, the rise of ESG investing has come with some pain points.

Figure 1.3 What is the approximate share of all ESG investing in your pension plan's portfolios currently?



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"Before 2021, the world was putting $1 trillion a year into green fuels and transmission systems. Now, it is $1.4 trillion."

"ESG investing has so many moving parts that it is unlikely to progress smoothly without periodic setbacks."

Theme 4 ESG investing is entering a more demanding phase

Thus, investing responsibly is set to become a driver of long-term returns and positive change.

The days of stellar growth in ESG assets are probably over – for now – as pension investors become more demanding. The majority still expect to increase the share of ESG investments in their portfolios over the next three years (Figure 1.4): 53% in active portfolios and 49% in passive ones. The key drivers are major policy developments in key regions. They vary in scope and speed of execution, but their end-goals are similar.

Last year, the US finalised the Inflation Reduction Act, unleashing $369 billion of tax incentives to spark transformative innovations in battery storage, hydrogen, carbon capture and energy efficiency. EU policymakers soon followed suit by unveiling their Green Deal Industrial Plan to increase the competitiveness of Europe's net zero industry so as to hasten the transition to climate neutrality. Since then, India also launched its ambitious Production-Linked Incentive Scheme to spur new renewable energy technologies.

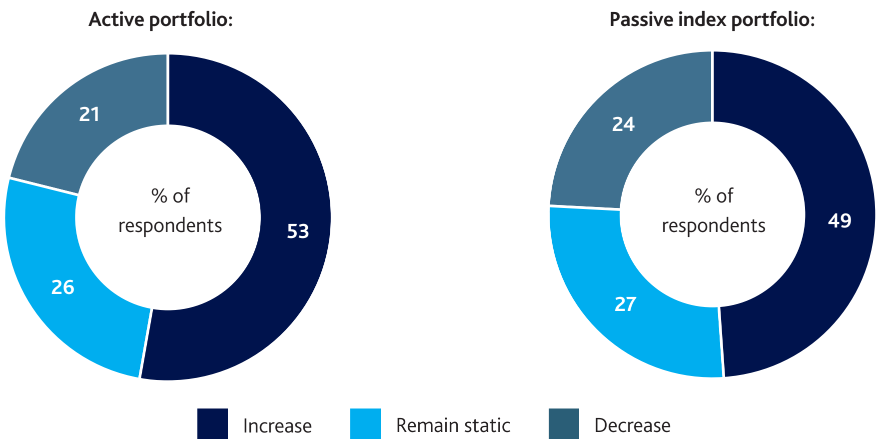
Climate action thus has powerful tailwinds from broad-based policy action with a twin focus on innovation and high-emission hard-to-abate sectors such as aviation, cement and steel.

To cap it all, some 190 countries signed the UN's landmark Kunming-Montreal Global Biodiversity Framework in December 2022 to mobilise some $200 billion per year in biodiversity-related funding from public and private sources.

To maintain momentum, there are regulatory changes in the works on the mandatory disclosure of ESG risks and improvements in the quality of the existing data infrastructure (shown in Section 3). But the tidal wave of regulation, especially in Europe, is seen as creating extra bureaucracy. The mass downgrading of ESG funds at the start of 2023 and the continuing lack of clarity around what constitutes 'sustainability' in SFDR means that around one in every five expects to decrease their ESG allocations (Figure 1.4).

On the positive side, policy and regulatory changes will not only send clear pricing signals to capital markets about ESG risks and opportunities; they will also improve transparency across the ESG value chain. Thus, investing responsibly is set to become a driver of long-term returns and positive change. More than ever, that's what pension plans want: to make a difference.

Figure 1.4 How is this share of ESG investing likely to change over the next three years?



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"Policy response on climate action had been very slow. But lately the switch has been flipped."

"The EU's Green New Deal is a potential game changer. It will affect how we allocate assets."

Theme 5 Inherent trade-offs are adding to complexity

The early phase of ESG investing mostly bundled the three pillars together, using composite data from rating providers. However, recent growth has seen greater granularity between and within the pillars. Currently, environment attracts the highest ranking, followed by social and then governance (Figure 1.5). But the story is far more nuanced.

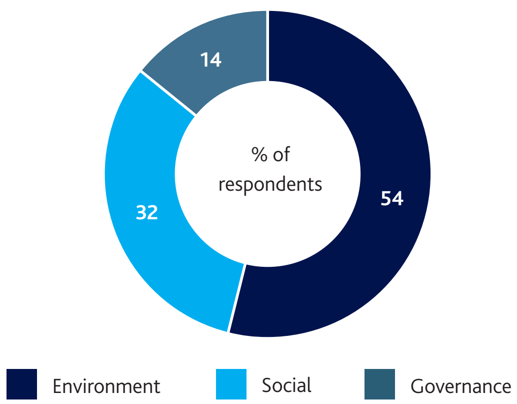
First, the ranking varies across three key pension regions: in Asia-Pacific, the predominant emphasis is on governance; in Europe, it is on environment; and in North America, it is on social. Differences in regulation are a major factor here.

As pension plans have progressed up the learning curve, they have faced tough trade-offs, requiring judgement calls.

Second, within individual pillars, there are clear differences in emphasis, as shown in Figure 4.1 in Section 4. In the environmental pillar, decarbonisation and biodiversity top the list. In the social pillar, it is employee engagement and diversity & inclusion. In the governance pillar, it is executive compensation and corporate board composition.

Third, as pension plans have progressed up the learning curve, they have faced tough trade-offs, requiring judgement calls: for example, who actually pays for ESG goals?

Figure 1.5 **When considering ESG investments, which component do you consider to be the single most important?**



Source: Amundi Asset Management / CREATE-Research Survey 2023

Convincing companies in the hard-to-abate commoditised sectors, such as steel, cement and aluminium, to go green is a considerable challenge. When competing on a global basis, raising prices is not an easy option for them, nor is cutting dividends. Good yield is what attracts investors to these smokestack sectors in the first place.

Another trade-off centres on stranded carbon assets, caused by premature write-downs well ahead of their economic life as part of climate action. Academic studies show that up to 80% of the known fossil fuel reserves of publicly listed companies today face this prospect, inflicting severe economic hardship on local communities as workers lose their jobs. A just transition remains a formidable challenge.

Yet another trade-off centres on the Ukraine war. First, whether it is ethical to invest in controversial weapons manufacturers who are helping Ukraine fight Russian aggression.

Another considers whether traditional oil and gas companies should still appear on the exclusion list as they seek to plug the energy shortfall caused by the war.

Social media giants, with their emphasis on talent, now score high on the social factor, but there are serious concerns on how uncensored material on their platforms harms political stability in democracies and children's well-being.

Indeed, with the rise of Generative AI, it is questionable whether these tech Leviathans count as ethical investments anymore. They also have an immense unregulated influence on our opinions and world views.

On the flip side, however, there are also positive interdependencies between the ESG pillars: investing in biodiversity can improve the earth system and human health. Good governance can help set high standards for the E and S pillars.

Interview quotes

"The electric vehicle supply chain includes illegal mines and child labour: hardly a paragon of virtue."

"Companies can't invest in the long-term benefits of ESG unless investors ditch the 'get rich quick' mindset of quarterly capitalism."

Theme 6 Growth has outpaced capacity creation

Until the 2022 market rout, growth in ESG assets had been exponential. But the rise of its supporting infrastructure of skills and data has been, at best, linear. The resulting capability gap is shown in the sub-par assessment of asset managers (Figure 1.6, left chart). Only 8% are rated 'excellent', and a further 22% are rated 'good'. The remaining 70% are rated 'fair' or 'poor'. Charges of greenwashing have come under regulatory scrutiny.

Charges of greenwashing have come under intense regulatory scrutiny.

The 2022 report from the non-profit US SIF Foundation is illustrative. By adopting refined methodology and reporting, it nearly halved the size of the US sustainable investment universe to $8.4 trillion in 2022 from $17.1 trillion in 2020. A similar downgrade happened in the EU after the SFDR regime beefed up its disclosure rules.

The US SIF research came after the Securities and Exchange Commission (SEC) released two proposals: one to prevent misleading fund names and another to require greater transparency around funds' use of ESG factors. However, at least some of the greenwashing may be unintentional, reflecting the teething problems of a new and better way of investing, as argued in Sections 2 and 4.

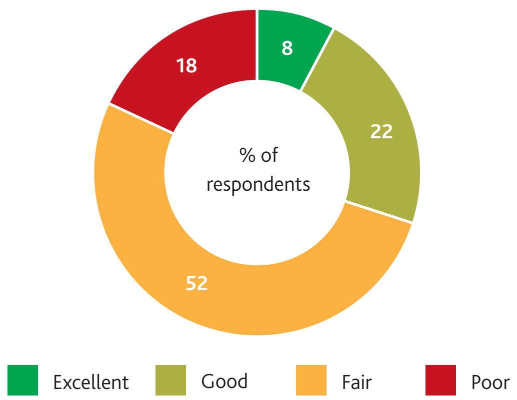
To provide a robust reality check, stewardship and proxy voting have become a vital issue in manager selection. This applies to active and passive funds (Figure 1.6, right chart).

In the past, passive funds have been stereotyped as lazy owners of companies not exercising their clout. The result is ownerless companies. This is in marked contrast to current thinking among our survey respondents. They believe that since passive funds cannot divest their positions in poorly performing companies, they are forced to be long-term investors. They have every incentive to exercise their stewardship role to boost the quality of beta by harnessing the sheer weight of their holdings.

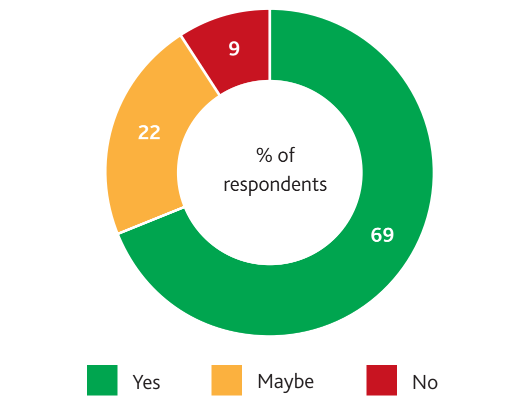
They want their voice heard on hot-button issues like strategy, governance and ESG. Besides, the active risk in ESG indexes has been rising as they target specific themes that require a higher tracking error despite the use of portfolio optimisers. Thus, the term 'passive' applies less and less to ESG investing.

Figure 1.6

How do you rate the capabilities of the external asset managers you currently mandate in achieving your pension plan's ESG goals?



Are stewardship and proxy voting just as relevant in passive funds as they are in active funds?



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"In ESG investing, hope has run ahead of reality. Greenwashing is the outcome."

"Stewardship and proxy voting are as important as asset allocation, if not more so."

2 The rise of purposive capitalism

What is new, what is different?

Overview

This section highlights the current state of progress on ESG investing and the forces that have been shaping it recently. It covers three issues:

- How is the ecosystem of capital markets now being reshaped by ESG investing?
- Why does the net zero climate goal mark a new era in climate finance?
- Why have developed market assets featured more visibly than emerging market assets in ESG investing?

Key findings

a. The changing ecosystem

Old-style capitalism, with its sole focus on profits, is being reshaped with the rise of ESG investing that aim to factor in those negative externalities that have long imposed uncompensated costs on wider society. In descending order of importance, the avenues used are:

- stewardship and shareholder engagement;
- focus on 'best in class' ESG companies with high or improving scores;
- integration of ESG factors in the investment process;
- exclusion of companies with poor ESG ratings;
- impact investing that targets a double bottom line.

"The interests of business and wider society are much more intertwined than ever."

An interview quote

b. The net zero pledge

Pledges made before, during and after COP26 in 2021 are creating pathways for the decarbonisation of the global energy sector. So far, one in every two pension plans has a net zero strategy and a further one in four reports 'work in progress'. However, only one in six has set interim goals and milestones. The trajectory will benefit from fresh tailwinds from two recent policy game changers: the Inflation Protection Act in the US and the 'Fit for 55' programme in the EU. Further impetus is likely from industry collaborative ventures such as New Zero Asset Owner Alliance and Net Zero Asset Managers Initiative.

In descending order of importance, five investment strategies feature in the advance towards the net zero goal:

- equities
- bonds
- alternative investments
- Paris climate benchmarks
- Article 8 and Article 9 funds in the EU's SFDR.

c. Developed versus emerging markets

Developed markets had a head start in ESG investing due to regulatory and societal pressures, while emerging markets have been intent on raising the basic living standards of their citizens.

However, the gap is expected to narrow over time due to:

- EM companies coming under pressure from their trading partners in the West to up their ESG game following new policy measures;
- blended finance projects coming under the 'loss and damage' mechanism agreed at COP27 in 2022.

Currently, ESG investing mostly relies on bottom-up security selection. Over time, as ESG becomes a compensated risk factor, it will become part of top-down strategic asset allocation with its own policy benchmark.

The ecosystem of capital markets is changing

With negative externalities like climate degradation and economic inequalities now glaringly evident, old-style capitalism is undergoing its biggest ever makeover.

Its key motive to make profit is now infused with a higher purpose for companies to promote the interests of shareholders as well as employees, customers and the communities in which they operate.

ESG principles are central to this narrative. This scenario has been reinforced by the Covid-19 pandemic, which exposed major system-wide risks – especially climate change, racial injustice and social inequality – and highlighted companies' vital role in tackling them.

The financial materiality of the inherent risks is now widely accepted as gradually reshaping the ecosystem of capital markets.

The financial materiality of the inherent risks is now widely accepted as gradually reshaping the ecosystem of capital markets. This is clear from the different approaches now being used by survey participants (Figure 2.1).

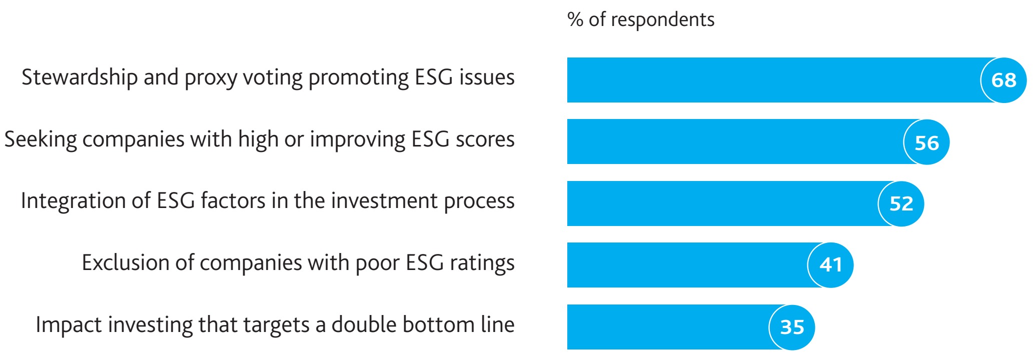
They distinguished between *ESG-integrated* strategies and *ESG-focused* strategies. The first set centres on single materiality by identifying external financial issues that can impact an investee company's own business performance. The second centres on double materiality: it enjoins asset owners to look beyond the impact of ESG risks on their portfolios to assess how their investee companies' own activities affect social, economic and environmental systems.

Taking the two sets in turn, three approaches target single materiality. Those in the early phase of their ESG journey now rely on the exclusion of so-called sin stocks: shares in companies linked with activities deemed unethical such as tobacco, controversial weapons, fossil fuels and poor labour standards (41%).

While not ignoring negative screening, other survey participants now also rely on the overt integration of ESG factors in their investment process and decisions for different asset classes (52%). Yet others rely on a variant of this approach: they invest in best-in-class companies with high or improving ESG scores (56%).

This version mimics the traditional style factor that favours high-quality companies or those with high-return potential. The last two groups above believe that negative screening is less effective: it merely reshuffles asset ownership. It is far better to engage with such companies and improve their ESG credentials than ditch them altogether. The transition to a low-carbon future will not succeed without their active involvement. That is why some carbon polluters are included in an otherwise green index such as FTSE4Good. Energy companies can be both part of the problem and part of the solution. Indeed, those included in the index are seen as being part of the solution.

Figure 2.1 **What are the dominant approaches that your pension plan currently uses in its ESG investing?**



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"Companies are becoming aware that they need a social licence to operate."

"Active ownership and stewardship sit at the heart of ESG investing."

Stewardship is about being an active owner of the business, not just a holder of paper assets.

Turning to approaches that target double materiality, two are noteworthy. One is impact investing that aims for both financial and non-financial benefits (35%). Within the overlapping space of ESG and the UN's 17 Sustainable Development Goals, they target those themes that are part of long-term secular growth trends. They cover sectors that are being reshaped by life-changing megatrends that drive disruptive innovation, transform business models and reshape public and corporate policies. They seek to generate a positive measurable social or environmental impact alongside financial returns. Indeed, returns and wider impacts are seen as interdependent.

Another approach is stewardship and proxy voting that overtly aim to drive progress on ESG themes (68%). It is the most popular approach, especially while the infrastructure of skills, data and technology is evolving slower than the demand for ESG-related funds. It serves to pinpoint what ESG investments are actually delivering on the ground and how portfolio companies can be encouraged to up the ante. Stewardship is about being an active owner of the business, not just a holder of paper assets. It recognises that there needs to be clear alignment between corporate strategy and existential multifaceted climate risks (see Insights).

All five approaches address the fact that ESG can be considered to be a financial metric that aims to minimise the financial harm that negative externalities can cause to a company as well as how its own operations can minimise their negative impact on our planet and its people.

Interview quotes

"Is this the magic moment to reinvent investment discipline?"

"There are no shortcuts in ESG investing. It takes time, skill and patience."

Insights

Navigating climate risks is a Herculean task

Some 140 countries have signed up to the net zero initiative to decarbonise their economies. The world's economy will become much less carbon intensive over time. But at what speed?

Physical risks from extreme events like droughts, forest fires, hurricanes, rising oceans and coastal flooding hit asset values and physical infrastructure.

Then there are transition risks from economic obsolescence, resulting in stranded assets in fossil fuel and other sectors that fail to adapt.

There are also two less frequently cited risks that are often subsumed under the transition category. They are litigation risks, as third parties seek compensation from collateral damage, and systemic risks, as asset prices fail to reflect climate risks.

Identifying these risks is one thing, managing them is quite another. Scientific estimates of the likelihood of future climate scenarios vary widely. Complicating the task is their non-linear trajectory: the longer corrective climate action is delayed, the more draconian the eventual actions will need to be.

The fact that many risks are linked in the effects they jointly produce adds to the complexity. Equally, there is little doubt that the transition to a low-carbon world will bring investment opportunities: for example, personal mobility will increasingly rely on new greener solutions.

Besides, as universal owners, we have stakes in thousands of companies worldwide. We are not legally responsible for their environmental pollution, but we have a moral obligation when it does uncompensated harm to the wider economy and society.

A Dutch pension plan

Net Zero marks the second era of climate finance

The pension sector is still in the foothills of net zero action: so far, only around 15% have set interim goals and milestones that emphasise the urgency of climate action.

The history of climate action can be split into two time periods. The first era was formalised globally by the creation of frameworks after the Paris Agreement, making commitments and scaling up renewables in developed economies. The second era is about implementing the pledges made by governments, investors and corporates made at COP26 to create a pathway for the global energy sector to achieve net zero carbon emissions by 2050.

The need for urgency is underscored by the latest assessment from the International Energy Authority that the window of opportunity to achieve a 1.5°C climate outcome is closing at worrying speed.

For their part, pension plans have been adopting the net zero goal (Figure 2.2, left chart): 23% have an overt strategy and a further 28% report 'work in progress'. Thus, the pension sector is still in the foothills of net zero action: so far, only around 15% have set interim goals and milestones that emphasise the urgency of climate action, according to our interviews.

After all, the credibility of net zero pledges rests on three criteria: whether they target science-based emission reductions; whether they have clear interim targets; and whether executive compensation is aligned with the Paris goal. In each case, a notable start has been made. It is now experiencing powerful tailwinds from two recent gamechangers that are creating incentives and sanctions for capital markets to price in climate risks on a broader scale.

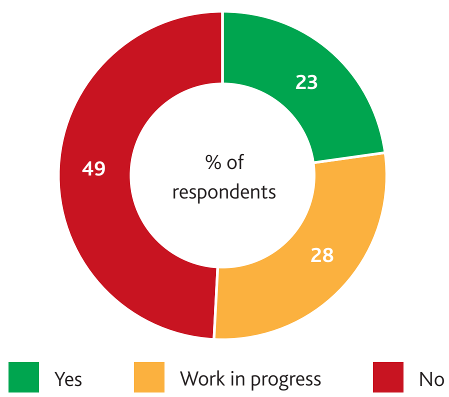
One of them is the 2022 US Inflation Reduction Act, which vastly expands the supply of investable projects in clean, renewable energy via generous tax incentives – initially involving $369 billion that could leverage $1.4 trillion of private investments over time. They will likely provide a big boost for nascent energy technologies, including carbon capture, enabling them to progress swiftly down the cost curve, just like wind and solar before them.

The second policy initiative is the European Union's 'Fit for 55' programme of action (see Insights on page 18). In breadth and depth, it has no precedent.

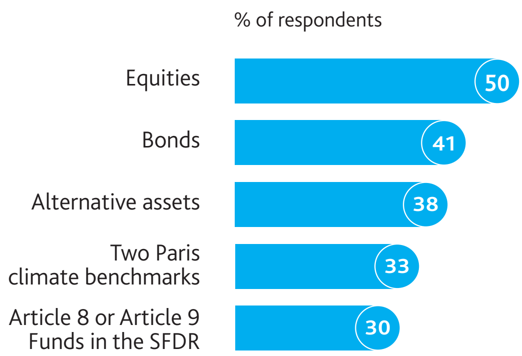
Unsurprisingly, global ESG assets are predicted to rise to $50 trillion by 2025, from $41 trillion in 2022, according to Bloomberg Intelligence. A broad range of asset classes are already being used (Figure 2.2, right chart).

Figure 2.2

Does your pension plan have an overt strategy for achieving the net zero climate goal by 2050?



If 'yes', which asset classes and approaches are being used?



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"The recent energy crisis has reinforced the urgency of the shift to a low-carbon future based on renewable energy."

"China's green bond market has come from nowhere to become the largest in the world."

The grey-to-green transition is seen as a generational investment opportunity, as policymakers put the right structures and incentives in place.

Equities top the list (50%). There are three reasons for this: they permit strong stewardship and engagement; they offer ready liquidity while markets remain directionless; and they can readily target 'pure play' ESG business models like renewable energy, as well as hard-to-abate sectors, such as cement and steel, and encourage their transition towards a low-carbon future.

Bonds come second (41%). As ever more pension plans advance into their run-off phase due to ageing demographics, green, social, sustainability-linked and a mix of green and social sustainability bonds have become attractive, with their use of proceeds provision at project level, which helps impact monitoring. However, the inherent complexity of bond markets – given their size, variety of instruments, maturities and issuing entities – makes it harder to integrate ESG issues into credit assessments, especially interest rate and liquidity risks.

Alternative assets come third (38%). Their emphasis is on green infrastructure, green buildings, private equity and private debt in that order of importance. In particular, private equity is well positioned to buy the worst ESG laggards and improve their green credentials both with and without tax incentives. Such laggards are seen as the best investments at today's prices and make the largest real-world impact.

Finally, there are two recent innovations from the EU. One is the Paris Aligned and Climate Transition benchmarks (33%). They are seen as a major advance, since they target an absolute 1.5°C scenario. They also have a formal decarbonisation trajectory, unlike the previous generation of indices. In contrast, previous low-carbon indices merely sought to reduce emissions relative to their parent index. The other innovation centres around Article 8 and Article 9 funds under SFDR (30%). Both seek to tackle greenwashing by offering clear transparency around ESG funds. But they have, of late, attracted critics, as discussed in Section 3.2.

Overall, the grey-to-green transition is seen as a generational investment opportunity, as policymakers put the right structures and incentives in place.

Interview quotes

"The global issuance of green bonds reached the $2 trillion milestone in 2022 during a difficult year. Growth has resumed in 2023."

"The biggest investment opportunities will be in hard-to-abate sectors as they transition towards a low-carbon future."

Insights

EU policy action will send clear signals to capital markets

The 'Fit for 55' initiative signals the EU's goal to cut greenhouse gas (GHG) emissions while supporting the most vulnerable citizens and sectors in the transition phase via the new Social Climate Fund. It aims to reduce GHG emissions by at least 55% (compared with 1999 levels) by 2030, and for carbon neutrality by 2050.

Demand for fossil fuels will be curbed by reductions in carbon quotas in the EU Emissions Trading System. The system will be extended to new sectors like maritime transport and international aviation. A new trading system is now being created for sectors like road transport and buildings. The initiative also sets binding annual emission reduction targets for member states in sectors not currently covered in the EU ETS.

Finally, the Carbon Border Adjustment tax will be used to ensure that the emissions reductions are not offset by the relocation of production outside EU borders via regulatory arbitrage. For now, the timing of these measures is unclear because of current legislative backlog in the European Parliament.

The programme is being driven by two laws passed in 2022: the Net Zero Act and the Critical Raw Materials Act. One is in response to the US Inflation Reduction Act; the other is a device to rein in green industry's global leader, China. Both aim to make the EU the home of clean technologies and green jobs. However, owing to energy security concerns from the Russian invasion of Ukraine, progress will be gradual.

A German pension plan

Developed markets have a head start in ESG initiatives

Climate change has no regard for national borders or geographies. Yet, responses to it have varied across regions and reflect the uneven pace of economic development. However, given their rising share of GHG emissions, the battle against climate change will be won or lost in emerging markets.

Companies in developed markets launched their ESG initiatives decades earlier in response to stronger pressure from regulators and society. In most emerging markets, by contrast, the policy focus has thus far been on economic growth, rather than its ESG impact. Industries at the heart of this economic catch up (such as cement, steel and chemicals) are also hyper emitters. To make matters worse, for decades, developed economies have been offshoring some of their most heavily polluting manufacturing activities to their emerging market peers.

For decades, developed economies have been offshoring some of their most heavily polluting manufacturing activities to their emerging market peers.

This unbalanced progress is duly reflected in the asset allocation approaches of our survey participants (Figure 2.3, left chart). In every asset class, developed markets rank highly, followed by emerging markets and then frontier markets, duly raising the hurdle rate of return for latecomers. As things currently stand, participants' total allocation to the latter two markets are around 8% on an asset-weighted basis. ESG assets account for just under half of it, focused principally on green bonds.

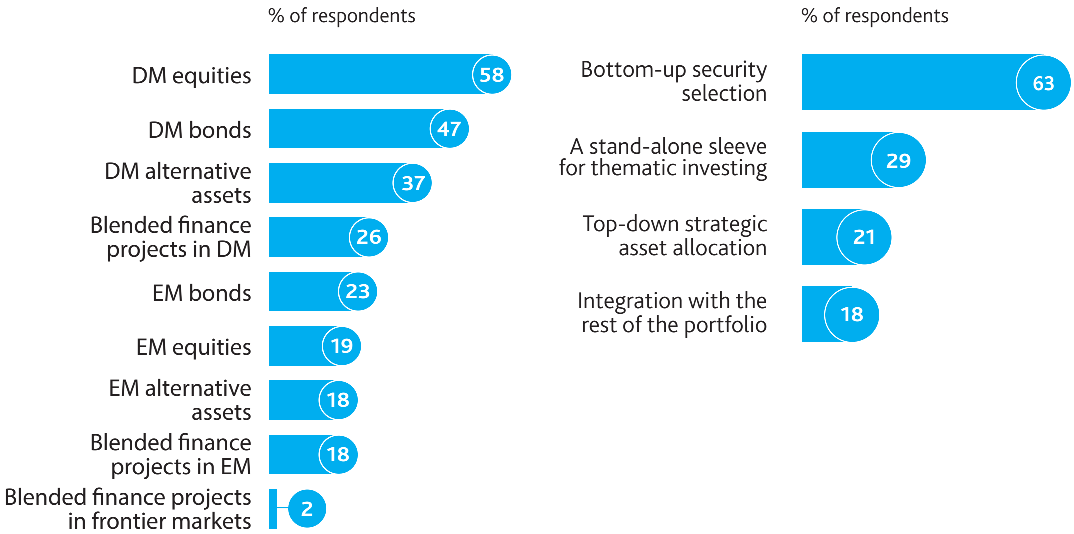
As a cohort, emerging market companies lag behind their developed market peers in ESG ratings. And the gaps are wide in every ESG pillar, according to the data provider Refinitiv. The gap is unlikely to be bridged in the near term: emerging markets need to make sizeable investments in climate mitigation and adaptation projects.

But not all emerging markets are equal (see Insights on page 20). Two prospective developments are expected to narrow the gap. First, with their strong trading links with America and Europe, emerging market multinational companies are coming under increasing pressure to up their game, as the EU starts to impose higher carbon taxes on

Figure 2.3

Which asset classes are deployed in your ESG investments currently and/or are likely to be deployed over the next three years?

How do ESG factors appear in your overall investment portfolio currently and/or are likely to appear in it over the next three years?



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"In most emerging markets, the policy focus has been on growth rather than on environmental impact."

"It is insufficient to just cut and paste the frameworks used to assess developed market assets into the EM space."

The advantage of being part of Strategic Asset Allocation with its own policy benchmark is that ESG investing is no longer constrained by the traditional cap-weighted benchmarking framework.

its imports. Additionally, along with Australia, Canada and the US, the EU is also imposing tougher rules on imports tied to child or forced labour.

Second, building on the Just Energy Transition Partnership first set up after the Glasgow COP26, two initiatives from COP27 in 2022 are set to promote blended finance. One is the launch of the 'loss and damage' mechanism that promotes climate adaptation projects. The other is the Energy Transition Accelerator, which aims to create a new class of carbon offsets to speed up renewable energy projects in emerging countries. Relying on concessionary finance from multilateral institutions within a public–private partnership, blended finance funds, on average, leverage $4 of private capital for every $1 of concessional capital. Chile, Egypt and Indonesia are already making strides in this arena.

Hence, our survey participants are also refining their asset allocation approaches as they move up the learning curve (Figure 2.3, right chart).

First, starting with bottom-up security selection, ESG investing has been through some refinements. While it remains the main avenue of allocating assets to ESG pillars (63%), the ESG pillars are now also featuring in top-down strategic asset allocation (21%), as they gradually become compensated risk factors, similar to other long-established ones like inflation, GDP and interest rates. Currently, ESG is reportedly a compensated risk factor in Europe, but less so in America and Asia, according to our post-survey interviews.

The advantage of being part of Strategic Asset Allocation with its own policy benchmark is that ESG investing is no longer constrained by the traditional cap-weighted benchmarking framework.

The second area of refinement is the rise of thematic investing (29%). It falls within the traditional core–satellite model, where the core focuses on liquid assets in efficient markets and the satellites cover assets with high growth potential across sectors and regions. It tends to pursue multiple themes in addition to ESG and perform periodic tactical switches to capitalise on periodic alpha opportunities.

Securitisation is another nascent growth area in ESG. It is becoming mainstream in solar panel leases and car loans dedicated to electric vehicles, which can be securitised and sold to investors.

Interview quotes

"Impact investing remains the best vehicle for ESG because of its emphasis on measurable financial and social outcomes."

"The advance of ESG in strategic asset allocation is a matter of when, not if. "

Insights

China set to become the green energy superpower

Despite being a latecomer, the Chinese domestic green bond market has gone from zero to hero to become the largest in the world. This has come as the government set an emissions peak in 2030 – the first nation to do so – and also set a net zero target by 2060. Requiring $14.7 trillion to fund these goals, the Chinese green bond market is growing at a CAGR of 14% and is now the biggest in the world. It provides a good diversification hedge in view of low volatility, low default rates outside the real estate sector and low correlation with developed markets.

Green bonds also enjoy preferential status in collaterals in the central bank's medium-term lending facility.

This growth has coincided with the launch of the EU–China 'Common Ground Taxonomy'. It aims to improve the comparability and future interoperability of their respective green taxonomies. It has laid the foundation for much-needed harmonisation on green projects, green assets and the definitions of associated activities.

The country is also the world's largest investor in climate transition technologies and controls vast swathes of key supply chains in key technologies like solar cells and sodium ion batteries.

Last but not least, China is now the leading supplier of the wind turbines and solar panels that are driving the global revolution in renewable energy.

A Hong Kong pension plan

3 Blockers and drivers

What has hindered ESG investing and how will that change?

Overview

Crises tend to accelerate trends. The upheavals of 2020 — from the global pandemic to the movement for racial justice and the ongoing threat of climate change — provided powerful tailwinds for ESG investing. Lately, there have been signs of a slowdown, as ESG returns suffered in 2022 and the war in Ukraine improved the fortunes of the oil and gas sector.

Against that backdrop, this section covers three issues:

- Which factors have acted as a drag on the ESG advance?
- Why has the EU's SFDR suffered a setback?
- How have regulators and governments responded to ease the drag and generate pricing signals for capital markets?

"Without incentives and sanctions, capital markets have a tendency to avoid pricing ESG-type risks until they are staring them in the face."

An interview quote

ESG-related topics have never been so central to the investment conversation. Assets are growing and the connection between ESG and risk is strengthening. But the 2022 market debacle changed the dynamic – from quantity to quality – by exposing the limitations of the ESG model. These mattered less when performance was in line with expectation; now, the burden of proof that ESG works has intensified.

Key findings

a. Slowdown in progress

Five contributory factors have been at play:

- energy stocks gaining the upper hand over decarbonisation goals;
- clear recognition that ESG has a data problem;
- the political backlash against ESG in the US, which has the largest pension market;
- the lack of a coordinated intergovernmental approach to climate and social issues;
- capital markets' struggle to price in ESG risks.

b. SFDR setback

Two big waves of downgrades in SFDR in 2022-23 have invoked diverse views.

Some dismiss downgrades as teething problems, while others see SFDR as a robust anti-greenwashing tool over time.

Those who view SFDR negatively find it confusing, forcing them to revise their approach and dismiss it as ineffective in tackling greenwashing.

c. Progress by policymakers

Regulators and policymakers in key regions have recently pushed ESG's advance into mainstream investing, by focusing on:

- improving the clarity and comparability of data internationally by mandatory disclosure of ESG data;
- fiscal stimulus to accelerate the transition towards green energy.

These supportive measures are being augmented by:

- the rising impact of international networks supporting ESG investing;
- increased litigation against climate pollution and human rights.

Together, these drivers are helping to propel ESG investing into the mainstream. They rest on two beliefs: that the best regulatory approach is rooted in greater transparency, and that capital need carrots as well as sticks.

The connection between ESG factors and risk is strengthening; so is scrutiny across the value chain.

ESG has experienced headwinds recently

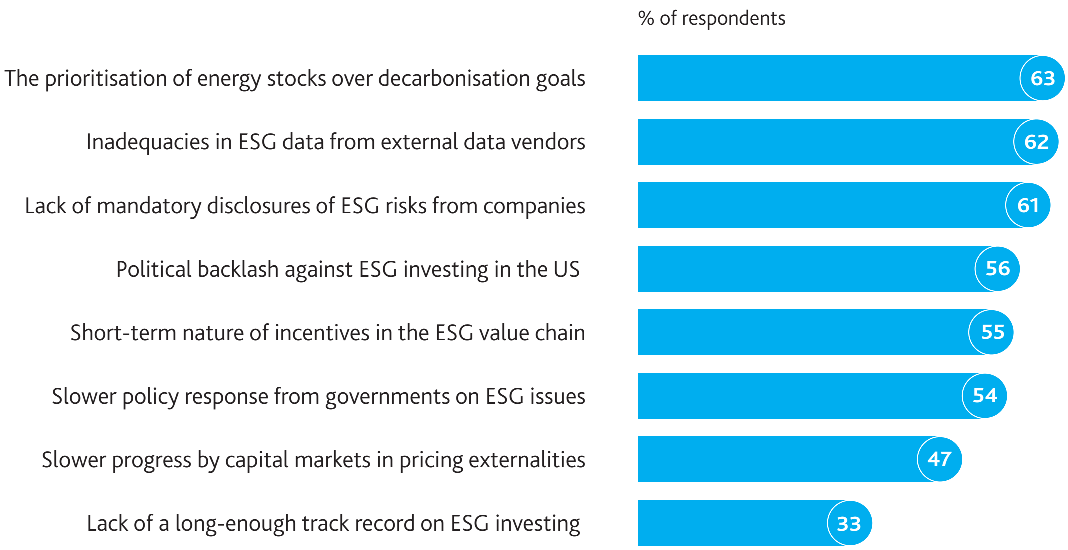
The 2022 market rout was caused by the withdrawal of central bank liquidity as inflation took off and the Ukraine war sparked the energy crisis. Companies with high ESG ratings suffered alongside most other companies. Such an abrupt reversal after years of good performance forced introspection among our survey participants: all the more so after a string of high-profile cases of greenwashing in the asset industry and flipflopping in the SFDR rules designed to curb it. Survey participants are now more demanding of their ESG investments, as mentioned in Section 1, to the point of slowing the advance of ESG over the past two years. Five interrelated considerations have argued for greater caution and scrutiny (Figure 3.1).

Despite recent progress, global consensus on how ESG performance should be defined and measured is slow to evolve.

First, with governments putting top priority on energy security for the near term, energy stocks have gained the upper hand over decarbonisation goals (63%). This has been a significant factor for pension plans lacking the strong funding ratios that require good returns.

Second, good returns also need credible audited data on the ESG risks that investee companies face and the opportunities they present. Data inadequacies have been a big drawback (62%). Progress on the mandatory disclosure of risks by listed companies has been patchy (61%), as are clearly defined standards of measurement and performance. Despite recent progress, global consensus on how ESG performance should be defined and measured is slow to evolve. Often, different data vendors have polar opposite views on a single stock. A dizzying army of them have their own approach to measuring ESG, with little consistency across markets and metrics (see Insights on page 24). This much is clear from the MSCI's recent downgrades of its ESG ratings in response to an upward drift across its fund universe. The changes mean that only 0.2% of funds will have a triple-A rating in the future, compared with 20% now. There remains a significant gap between what we know about ESG investing and what we need to know to make the right investment decisions. Investors need good ESG information at their fingertips, as with other financial data. Until they have that, they will continue to rely on bottom-up information from their own sources, as seen in Section 2 (Figure 2.3).

Figure 3.1 **Which factors have recently hindered progress in ESG investing?**



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"The politicisation of ESG in the US is a key driver of the outflows in 2022."

"We remain concerned about black box methodologies and inconsistent data from the ESG rating agencies."

Capital markets find it hard to fully price in ESG risks and opportunities until they are clear on how governmental actions will create essential sanctions and incentives in the short term for pricing externalities.

Third, such gaps have provided further ammunition to opponents in the US, where ESG investing has become a hot-button partisan issue. One presidential candidate is running entirely on an anti-ESG platform. Among others, under attack is the Securities and Exchange Commission's plan that would make climate risk disclosures mandatory. Also under attack is the November 2022 rule from the US Department of Labor, which allows retirement plan fiduciaries to consider ESG factors when making investment decisions. Such hostility, permeating the biggest fund market in the world, has unnerved our survey respondents (56%). They worry that their participation in collaborative ESG initiatives could expose them to accusations of collusion. Some US-based asset managers are now avoiding the term 'ESG' in a bid to placate ESG opponents. Indeed, this has weakened momentum behind the Glasgow Financial Alliance for Net Zero. It is stuck in neutral over oil and gas commitments.

Fourth, pension plans also worry about governments' ability to put aside politics and work together on ESG issues (54%). The recent decision by the European Commission to delay legislative action on its various initiatives is a case in point: the Emission Trading System and the Carbon Border tax are under pressure from vested interests in various member states. This is also evident from the recent backpedalling in France, Germany and the UK. Populism risks derailing the green transition. Governments have thus relied on capital markets to drive progress on climate action and social equity.

Fifth, for their part, capital markets find it hard to fully price in ESG risks and opportunities until they are clear on how governmental actions will create essential sanctions and incentives in the short term for pricing externalities (47%). Financial incentives for key players in the ESG value chain remain aligned to short-term targets (55%), because markets have a problem with the long term because of the tyranny of the discount rate.

Anything that happens to a company beyond 25 years out doesn't really seem to matter much. The result has been shorter time horizons, unrealistic expectations, a higher velocity of trades, momentum trading and a constant search for hot products.

Interview quotes

"Ironically, the anti-ESG states in the US will benefit most from the Inflation Reduction Act as they specialise in energy storage batteries."

"Carbon pricing versus voters' wallets remains a defining issue today, as shown by the gilets jaunes riots in France."

Insights

Data has been the Wild West of ESG investing

Our interest in ESG has not waned despite underperformance in 2022. But the sudden collapse of Silicon Valley Bank, with its top ESG rating, was a wake-up call about the worth of what we consider to be the lifeblood of ESG investing: the data we use.

So far, progress on the mandatory disclosure of ESG data has been piecemeal in Europe and the US. For now, we have used ESG standards from voluntary bodies like CDP, and the International Sustainability Accounting Standards Board. They differ a great deal in their scope and definitions. We have also used ESG filings as required by various stock exchanges. But the data they provide are self-selected and self-reported on a voluntary basis: only metrics that are self-serving are presented. They are not consistent across issuers and time; nor are they decision useful and forward looking.

Worst of all, there are over 150 ESG data vendors worldwide, using proprietary methods and weights that yield radically different assessments of the same company. What we need is mandatory reporting of consistent audited data that are standardised across the globe within a common timeframe.

We realise that the high correlation between data vendors means that markets will not come into being at all if buyers and sellers don't hold diverse views. But there does not seem to be an independent audit of the information we get from the vendors; nor, until this year, have these vendors been subject to the same regulatory scrutiny as the traditional rating agencies.

A UK pension plan

Issues around definitions have caused a setback for SFDR

There are fears that the SFDR could end up delivering the worst of both worlds: regulation that costs too much and delivers too little.

If there is one lesson learnt from the fund downgrade debacle in the SFDR, it is that the regulatory path for ESG investing will be anything but smooth. In their original form, the definitions of Article 8 and Article 9 funds involved a contribution to environmental or social objectives and 'do no significant harm' to such goals. In January 2022, the definition was made more restrictive. That led to a large-scale downgrading of funds by asset managers to avoid the risk of greenwashing.

Since then, the EU has introduced minimum standards for both fund categories, and instead allows asset managers to set their own standards and provide full transparency on their methodology. This has raised concerns about the dilution of standards, especially for Article 9 funds. The EU has also opened an extensive consultation on what changes are needed.

Survey respondents who have invested in SFDR funds have mixed views: initial concerns tinged with the hope that perhaps some good will come out of this unfortunate saga (Figure 3.2, left chart). The dominant response is one of confusion, which is forcing changes in investment policy in the near term (30%).

Allied to this group are others who believe that the SFDR will not have much effect, owing to the complexity that arises from its one-size-fits-all solution to greenwashing (18%). Indeed, some see the saga as an example of shifting regulatory goalposts just when clarity is most needed (12%). There are fears that the SFDR could end up delivering the worst of both worlds: regulation that costs too much and delivers too little.

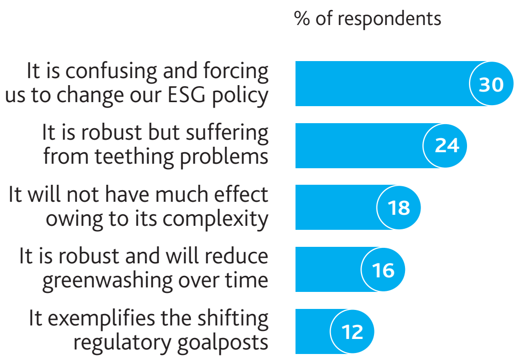
Yet there are others who take a pragmatic view because inherent in the notion of 'sustainability' are normative concepts, such as human rights and labour standards, whose meanings vary by region and culture (see Insights on page 26).

Some of them believe that SFDR is robust but suffering from teething problems that may ease in the foreseeable future (24%). Others hold the view that it is robust and will reduce greenwashing over time (16%).

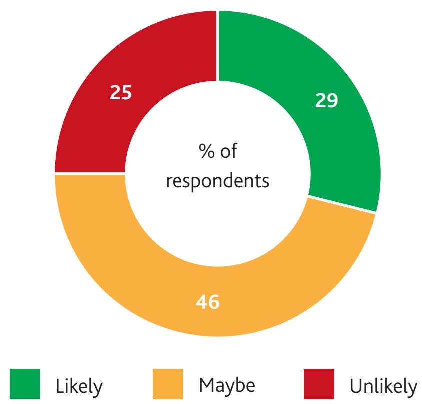
Both these groups hold the view that ESG is a journey of experiential learning where lessons from early trial and error will lead to gradual refinements over time. Suggestions on refinements have been made by the European

Figure 3.2

If you recently invested in ESG funds under Articles 8 & 9 of the European Union's Sustainable Finance Disclosure Regulation, what are your views on its effectiveness?



How likely is it that other regions will use the SFDR as a regulatory template in their own jurisdiction before long?



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"More work remains to be done in order to transform the EU's ambitious ESG legislation into a user-friendly framework."

"It is one thing having legislation, quite another making it work when it lacks clarity on cardinal issues."

That SFDR still has intrinsic merits is indicated by whether its regulatory template may be used or adapted in other jurisdictions.

Supervisory Authorities. Thus, SFDR is seen as the beginning of a long journey, not an end point. It is not set in stone.

That SFDR still has intrinsic merits is indicated by whether its regulatory template may be used or adapted in other jurisdictions (Figure 3.2, right chart): 29% say this is likely, 46% say maybe and 25% say it is unlikely.

Currently, other regions are preoccupied with creating their own ESG taxonomies. The EU taxonomy seeks to highlight the ultimate contribution of an economic activity to climate change mitigation or adaptation via the positive impacts of products and services that companies make. It, too, has had teething problems: for example, in its current form, it leaves out the positive impacts companies make towards the 'circular economy', described in Section 4. Its controversial decision to include natural gas and nuclear power after extensive lobbying by affected industries has been seen as retrograde. It sets a precedent for other industries, including aviation, to seek inclusion.

Such special pleading is evident in the proposed green taxonomy in Canada. It excludes new fossil fuel projects but allows existing projects to continue, provided they have limited lifespans and result in a real reduction in carbon emissions via carbon capture, utilisation and storage technologies in the production of oil, and blue hydrogen. Critics argue that this simply allows oil and gas companies to carry on business as usual. They also lament the exclusion of hard-to-abate sectors that have a critical role in a net zero world.

The most notable transnational collaboration has been marked by the launch of the EU–China 'Common Ground Taxonomy' (described in Section 2). It does constitute a start, although, in each case, the initiative has been substantially affected by local circumstances, before seeking interoperability on a global scale.

The same applies to the SFDR: its evolution and early lessons are taken on board in other jurisdictions, without mimicking it in detail. It may, however, provide a baseline for the potential development of international or cross-jurisdictional standards. This much is clear from the UK's proposed sustainability disclosure requirements for asset managers. They make every effort to maximise interoperability with new frameworks in the EU and the US.

Interview quotes

"Despite its limitations, we just need to get on with SFDR. It will be refined as it evolves. Rome wasn't built in a day."

"Other jurisdictions are taking on board some useful lessons from early SFDR challenges."

Insights

Recent flipflopping has hurt the SFDR brand

In late 2022, we saw swathes of downgrades of Article 8 and Article 9 funds, as the EU tightened its defining criteria. Since then, newly issued clarification means that we are now braced for mass upgrades, as asset managers are left to decide what constitutes 'sustainability' and then explain their methodology and criteria, while being held to minimum standards. Just as vague is the requirement that sustainable investments should 'do no significant harm' to the environment and society.

Ironically, such a subjective definition is the root cause of greenwashing: something SFDR was designed to prevent in the first place. The mass downgrades show that at least a part of greenwashing was unintentional.

On the upside, the lack of clarity on cardinal concepts in SFDR has ratcheted up the burden of proof for asset managers in two respects. First we now demand extreme transparency around our managers' ESG approach. Second, we want clear outcome metrics of our ESG investments, with regular timely reporting. Together, they will hasten progress on the data front.

The current travails of SFDR are likely to be the birth pains of a more robust version over time, as investors treat experience as the best teacher. As ESG investing continues to evolve, better data and methodologies will emerge.

A French pension plan

Regulators and policymakers are driving the ESG agenda

ESG investing will continue to go mainstream. Regulators and policymakers are now responding to the challenges identified earlier in this section with fresh initiatives (Figure 3.3). Top of the list are new regulatory changes on data disclosures by listed companies in key regions (61%). This is part of upping the ante on ESG as part of fiduciary duty (51%). The new rules require asset managers and investee companies to do what they say they're doing and be fully transparent about it.

The new rules require asset managers and investee companies to do what they say they're doing and be fully transparent about it.

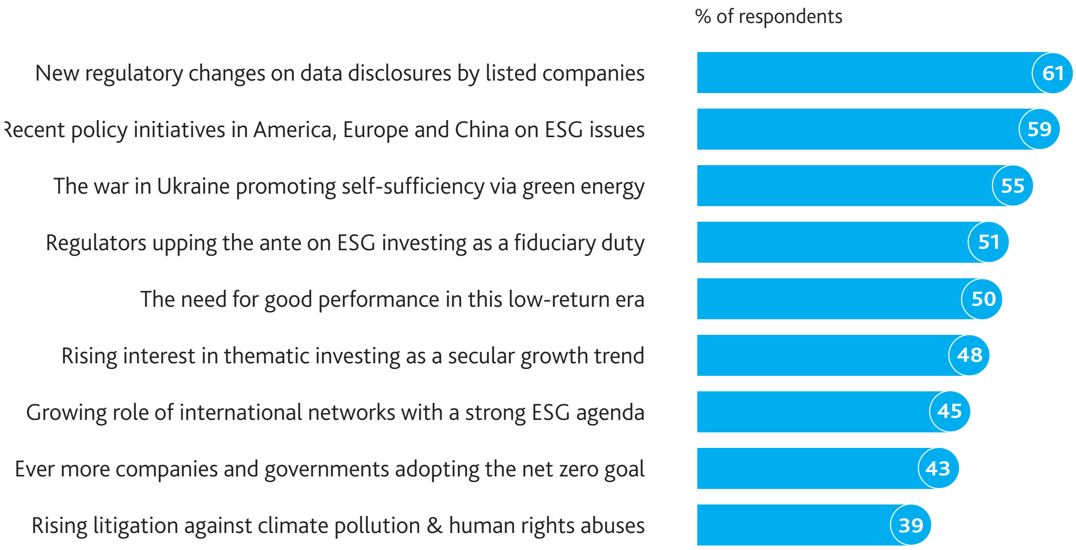
In the EU, the Corporate Sustainability Reporting Directive (CSRD) is expected to start improving the quality and quantity of corporate ESG data. The work on social taxonomy may have stalled, but plans are afoot to widen the scope of green taxonomy to include the circular economy, marine resources, biodiversity and pollution prevention. Furthermore, the proposed Green Claims Directive sets out rules for companies to prove their sustainability claims by providing independent supporting evidence, backed by regular checks and severe penalties. The aim is to wipe out misleading claims.

In the UK, the Financial Conduct Authority is acting in two areas: improving the quality of ESG-related disclosures made by index providers by bringing them under the regulatory umbrella; and introducing a new product labelling system to tackle greenwashing via its Sustainability Disclosure Regulation. The Pensions Regulator, too, has made the disclosure of climate transition activities mandatory for large pension plans.

In the US, the SEC is planning to issue three sets of rules this year. First, its climate disclosure rules require companies to disclose their GHG emissions – including Scope 3 emissions in their supply chains – and how climate change poses risks to them. Second, its fund-naming rule requires ESG funds to have at least 80% of their value in securities that correspond to that name. Third, its human capital management rules require companies to provide information on key aspects of their workforce practices. A sweeping climate law in California is set to force banks to disclose carbon emissions tied to their lending – financed emissions. For their part, data providers are already branching into forward-looking measures of decarbonisation.

The China Securities Regulatory Commission has now issued draft rules for consultation and the administration of independent directors of listed companies. The rules

Figure 3.3 **What will drive your pension plan's allocation to ESG investments over the next three years?**



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"Seven regions have made good regulatory progress since 2021: Australia, Canada, the EU, India, Thailand, the UK and the US."

"The new regulation in the US proposes tough emission limits and dramatically expands the electric vehicle fleet by 2032."

aim to strengthen their involvement in listed company supervision, governance and decision making. They establish a qualification system, a code of professional ethics, and a database for independent directors of all listed companies.

While regulators have been preoccupied with improving the infrastructure of ESG data, policymakers have been busy promoting ambitious initiatives (59%), as ever more governments and companies are adopting the net zero goal in pursuit of energy self-sufficiency (43%).

The EU has duly responded with the Net Zero Act and the Critical Raw Materials Act.

In the US, as mentioned in Section 2, the Inflation Reduction Act is likely to accelerate progress towards its net zero goal. Tax credits of $369 billion are likely to leverage private sector investments by a factor of four. Canada, too, is catching up with its southern neighbour with its own green tax credits, making it the second-most attractive market for renewable projects, behind the US.

The EU has duly responded with the Net Zero Act and the Critical Raw Materials Act, as shown in Section 2. The aim is twofold. First, to build manufacturing capacity for a host of green technologies. Second, to ramp up sourcing, processing and recycling for 16 listed strategic raw materials at the heart of an orderly green transition.

As shown in Section 2, China is also making big strides. Policy momentum there and elsewhere is serving to make ESG a compensated risk factor and thereby stimulate interest in thematic investing (48%) and enhance the role of global networks like the Task Force on Nature-related Financial Disclosure. Pension investors are thus targeting ESG factors while seeking good risk-adjusted returns in this era of low nominal returns (50%).

To cap it all, there is rising litigation against climate pollution and human rights abuses (39%). The pace was set in 2019 when the super oil major Shell was ordered by the Dutch courts to slash its carbon emissions by 45% (compared with 2019 levels) by 2030. Litigation is already a well-established engagement or escalation strategy for shareholders in the US. It is now coming to Europe, as indicated by another high-profile case, as filed by a group of European pension plans, this time involving Volkswagen for failing to disclose its climate lobbying.

Interview quotes

"If Texas was a country on its own, it would be the fifth largest producer of renewable energy in the world."

"Sweden is now incorporating its ESG requirements for pension managers into law, requiring exemplary investment practices."

Insights

Australia finally plans to catch up with other developed markets

Our advance towards net zero has been a tale of one step forward, one step back. Our biggest challenge was the lack of policy definition from federal government. Sitting, as it does, on vast reserves of high-grade coal, it has been reluctant to set any carbon-reduction targets for fear of creating stranded assets. It believed that the climate crisis would ultimately be solved by can-do capital markets. Regulations and fuel taxes only force firms out of business.

However, the election of a new Labour government last year has set a new forward-thinking path. It set a legally binding target to cut CO_2 emissions by 43% from 2005 levels by 2030.

More than 200 facilities have been targeted to reduce their emissions by 4.9% a year by 2030. Measures announced to date envisage increased transparency around climate outcomes and the scale of investment required.

Principal reliance is on green bonds to boost the scale and credibility of Australia's green finance market. The first sovereign green bond in mid-2024 will pave the way and seek to leverage private capital in big green infrastructure projects. It will get underway after the creation of a green bond framework and investor engagement. The framework will include a clear green finance taxonomy that would provide clarity on what a climate solution is and what it is not. Most likely, the new disclosure format will be modelled on the one in the EU.

An Australian superannuation fund

4 A rubric for progress

Where is the advance most evident?

Overview

Aims

This section highlights the progress being made in three areas in the ESG space:

- thematic investing
- impact investing
- manager selection criteria.

Key findings

a. Thematic investing

As trade-offs within and between the ESG pillars have become evident, so have differences in their respective risk profiles. A granular approach has gained traction. Within each pillar, favourites have emerged:

- in the environmental pillar – climate change and carbon emissions, biodiversity, water scarcity and waste management;
- in the social pillar – employee engagement and labour standards, diversity and inclusion, human rights, data protection and privacy;
- in the governance pillar – executive compensation, board composition, audit committee structure, and bribery and corruption.

"Respect for human rights is closely linked with value chain resilience and business stability."

An interview quote

b. Impact investing

Impact strategies have gained prominence since Covid-19, averaging about 5% of pension portfolios. With a limited investible universe of pure-play impact companies, it will advance at a moderate pace, as it requires financial returns and societal impacts to be interdependent.

As for the choice of assets, the most favoured are alternative investments in private markets and green, social, sustainability and sustainability-linked bonds in public markets.

The role of public market equities is somewhat constrained by a smaller universe of pure-play quoted impact companies and by markets' limited role in capital raising lately.

c. Manager selection criteria

As pension plans have advanced on their ESG journey, the list of criteria for selecting external managers for ESG investing has grown and now falls into two groups:

- Qualifiers, which cover the investment basics a manager needs to get right in order to have baseline credibility. They include the inclusion of core ESG values in corporate culture, a value-for-money fee structure, customised reporting and technological capabilities.
- Differentiators, which give managers a compelling competitive edge over their business rivals in the selection process. They include a proven track record in delivering clients' ESG investment and engagement goals, a deep and broad talent pool that is well versed with the systems theory that underlines complexity in ESG investing, widely admired thought leadership and proven capability in thematic investing and ESG advisory services.

However, progress in the ESG space as defined above comes with the concern that a faster transition to a low-carbon future will come at a price: it could be inflationary and pose a significant policy dilemma for central banks.

ESG will ride the current thematic investing wave

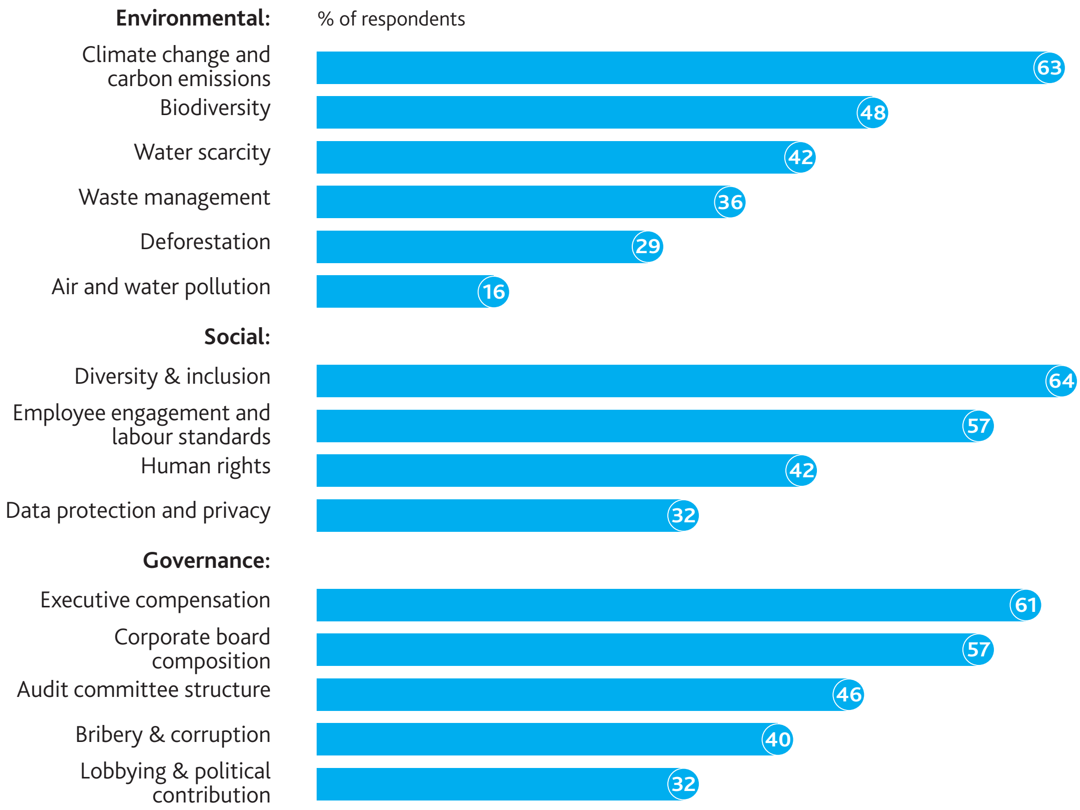
This interest in granularity was also inspired by stark contrasts in the nature of two types of risks that are embedded within individual ESG pillars: event risks and erosion risks.

In the early phase of their ESG journey, pension plans invested in vanilla single-score composite funds, only to discover, over time, that they are based on a huge oversimplification of a wide variety of factors that go into ESG. As pension plans progressed up the learning curve, the result was the rise of a granular approach within each pillar, as they became aware of the acute trade-offs between and within individual ESG pillars, as shown in Theme 4 in Section 1. This interest in granularity was also inspired by stark contrasts in the nature of two types of risks that are embedded within individual pillars: event risks and erosion risks.

Event risks are driven by short-term events, such as governance lapses or tax fraud, that can hit stock prices. A recent example is the sudden implosion of Wirecard in Germany once the fraud was exposed. Erosion risks, in contrast, can lower stock prices over time, as they unfold gradually. Climate change is a good example. Social factors, in turn, are exposed to both types of risks. Poor labour relations can hit profitability in the short term via industrial disputes and in the long-term via low productivity.

The emerging granular approach has favoured various themes (Figure 4.1). In the environmental area, at least one in three survey participants now favour four themes: climate change and carbon emissions (63%), biodiversity (48%), water scarcity (42%) and waste management (36%). These are seen as being some of the building blocks of a circular economy that aims to reduce

Figure 4.1 **Which themes currently feature highly or are likely to feature highly in your pension plan's investment portfolio over the next three years?**



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"Covid-19 has shaken our assumptions about the way we live and exposed the financial materiality of the social pillar."

"High-profile governance lapses have whipsawed share prices and cost us dearly."

GHG emissions and prevent biodiversity loss without compromising economic growth. Indeed, climate change and biodiversity are seen as interdependent. Global warming is not just a result of GHG emissions but also unsustainable land use and deforestation, which reduce the capacity of natural carbon sinks. In turn, climate change is a key driver of biodiversity loss.

Thus far, thematic investing has focused on 'pure play' companies in private and public markets where strategic purpose and business model are solely focused on the chosen themes.

In the social pillar, at least one in every three participants favours four themes: diversity & inclusion (64%), employee engagement and labour standards (57%), human rights (42%), and data protection and privacy (32%). All these themes have a normative dimension, which raises two challenges. First, standards in these areas can vary between cultures and regions: norms that are acceptable in one market may not be so in others. Second, these areas are seen as generating positive externalities that are observable, not measurable. As such, they are viewed as 'public goods' that come under the remit of governments. Yet societies now expect the private sector to have a role as well.

In the governance pillar, at least two in every five participants favour four themes: executive compensation linked to ESG outcomes (61%), diverse board composition (57%), an independent audit committee structure (46%) and zero tolerance towards bribery and corruption (40%). In the West, the current best practice governance model sees these features as most conducive to ESG investing. They indicate how the company's strategic vision and business values are aligned to ESG goals.

Thus far, thematic investing has focused on 'pure play' companies in private and public markets where strategic purpose and business model are solely focused on the chosen themes, like renewable energy and green infrastructure. Capital markets have less problem pricing them and delivering 'social' alpha.

In contrast, the incursion of thematic funds into the hard-to-abate sectors – like steel and cement – has been relatively low. Incentives and sanctions are currently less evident. Hence, current practice is to favour themes with greater conviction and evidence, and underweight those with a less supportive outlook.

Interview quotes

"It is plainly absurd to have to justify investing in our very survival or having to prove that we should stop funding what's killing us."

"There are no shortcuts to any place worth going. Thematic investing is no exception."

Insights

Thematic funds will potentially morph into impact investing

Our ESG investments have evolved from negative screening to integration into our investment process and then to thematic investing with a clear intention of producing quantifiable social and environmental outcomes, on top of decent financial results. Our chosen themes focus on long-term secular trends that outlive market cycles.

As the infrastructure of data and skills improve over time, thematic funds will likely morph into impact investing, which is our ultimate goal. Stewardship and engagement will play a huge role in that transition. As a universal owner, we have big equity stakes in companies with the highest potential to make the transition. We facilitate that by actively engaging with them to create actionable and profitable pathways towards the energy transition and the SDGs.

This incremental approach is essential in the absence of a universal definition and reporting frameworks on impact investing.

Currently, we use a number of different standards from independent organisations like the Impact Management Project, the Carbon Disclosure Project and the Task Force for Climate-related Financial Disclosure. But these add to the complexity in our investment process. This becomes apparent in climate-based funds. Some measure carbon footprint, some biodiversity and some water management. On the social side, too, some measure workforce diversity and some supply chain management.

This is inevitable, as singular composite metrics on corporate ESG scores have very limited worth in assessing outcomes.

A Swedish pension plan

Impact investing is at an early stage

So far, allocations to impact investing among a sample of our survey participants have averaged around 5% and are growing at a CAGR of 5%.

Four attributes make impact investing stand out from other ESG approaches. The first is *intentionality*: it has the express intention of achieving positive social and/or environmental impact. The second is *additionality*: it seeks to ensure that such desirable impacts would not have been possible without that investment. The third is *measurability*: it requires a robust framework in place to measure and report the targeted impacts regularly. The fourth is *financial impacts*: it differs from philanthropy by ensuring that a competitive financial return and impacts are interdependent.

While the required measurement frameworks are slow to evolve, these demanding features have ensured a lower adoption of impact investing, compared with other ESG approaches, as we saw in Section 2 (Figure 2.1). So far, impact investing has been the preserve of mainly universal owners with the necessary governance structures and skills that come with their global reach.

They target the delivery of at least risk-adjusted market-level returns (Figure 4.2). Only 14% regard this hurdle rate as non-essential, and even then only as long as the investments offer an acceptable level of positive absolute returns. Overall, impact investing is seen as an ideal diversification vehicle, as its returns are often uncorrelated with those of the mainstream market, according to those survey respondents already engaged in impact investing.

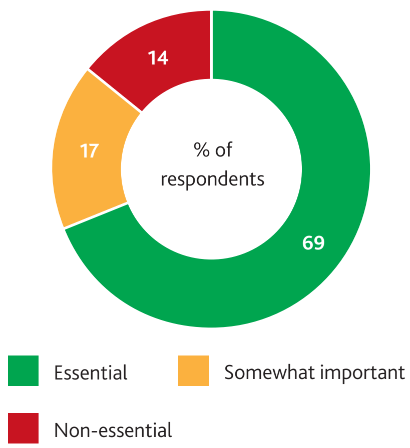
So far, its rise has been powered by the sheer scale of investments required by global collaboration in two flagship endeavours: the UN's SDGs, requiring an annual spend of $5-7 trillion by 2030, according to the World Economic Forum; and the net zero goals of governments and companies, requiring a cumulative spend of $100 trillion, according to the broadcaster CNN.

So far, allocations to impact investing among a sample of our survey participants have averaged around 5% and are growing at a CAGR of 5%. This reflects the modest pace of progress towards a commonly agreed measurement framework.

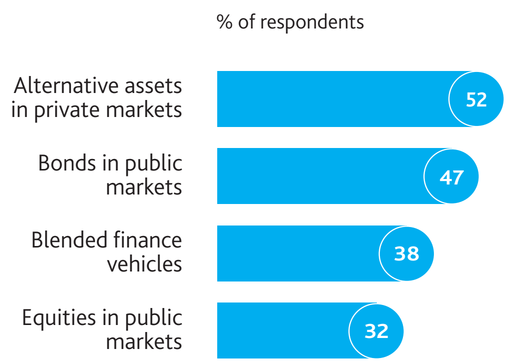
As for the choice of assets, alternative investments in private markets are most amenable to the four design attributes of impact investing, according to 52% of our

Figure 4.2

When it comes to impact investing, how essential are market-level returns to your pension plan, in addition to non-financial outcomes?



Which asset classes are most amenable to impact investing?



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"UN SDGs are the North Star for impact investing; they help us express our values in a granular way without sacrificing returns."

"In the pension space, impact investing has largely been the preserve of those who see themselves as universal owners."

There remain real concerns that the transition to a low-carbon future will stoke inflation, cause acute dilemmas for central banks and add a new layer of complexity to asset allocation.

survey respondents (Figure 4.2, right chart). Private equity, private debt and infrastructure top the list, given the customised nature of their mandates and reporting requirements. They also have corporate governance advantages, unlike other asset classes. Just as important are their long duration mandates, which allow for ESG risks – particularly of the erosion types mentioned earlier – to materialise.

Private equity firms are also well placed to participate in public–private partnerships within blended finance vehicles (38%). These typically cover new industries, new technologies and new markets focused on innovative impact solutions. Such vehicles offer two kinds of premia: investment premium, by backing high-conviction long-horizon themes; and leverage premium, by pooling their resources to create scalable investment strategies. These are essential, since advances in green hydrogen and carbon capture systems require high-risk capital up front.

Another favoured asset class is bonds: green, social, sustainability and sustainability-linked (47%). Despite the fact that they overly rely on a quantitative approach based on interest rates, inflation, credit quality and liquidity, they are seen as the most transparent vehicle for ensuring that investments have a real-world impact on top of netting financial results. This is because of the exclusive use of their proceeds towards financing projects with tangible impacts.

Finally, equities in public markets are at the bottom of the list (32%) for two reasons. First, while the number of pure-play impact companies in this area is growing, it remains small, giving rise to concentration risks. Second, public equities are principally traded in secondary markets and their role has changed over time – from providing investment capital for growing companies to a vehicle for cash distribution and balance sheet management that involves the second order trading of existing paper assets. The role of equity markets is expected to grow, as the quality of data improves and stewardship activities become central to impact investing. Indeed, large asset managers in public markets are also already in the blended finance space.

However, there remain real concerns that the transition to a low-carbon future will stoke inflation, cause acute dilemmas for central banks and add a new layer of complexity to asset allocation (see Insights).

Interview quotes

"The integrity of impact investing demands stringent criteria, but this slows its advance."

Active stewardship is vital in creating a common language and mental models about impact investing."

Insights

The green transition will not come cheap

The political backlash against ESG in the US is witnessing the rise of 'greenhushing': companies deliberately understating their green credentials. That's not the only worry we have. While the cost of energy from renewable sources will continue to fall, we shall also be entering a new era of inflation, owing to three forces.

The first stems from the direct impact of climate change itself: for example, exceptional droughts in large parts of the world will continue to raise food prices. The second force is inflation from the continuing high prices of fossil fuels due to the war in Ukraine. These are the legacy costs of not moving away from carbon fuels like oil and coal fast enough in the past. The third force is the high metal and mineral content of green technologies. Electric vehicles use six times the amount of minerals used in conventional cars. This is driving up the price of minerals like copper, cobalt and lithium. It takes up to ten years to open up new mines. Hence, the faster the transition to green energy, the more expensive it may become in the near term.

Thus, central banks face two policy dilemmas. One is whether they should raise their inflation target and risk denting their credibility or raise interest rates and slow the pace towards a low-carbon future. Another dilemma is whether they should exclude energy prices from their target measure of inflation because it is so volatile and risk the charge of massaging numbers to suit policy targets.

A US pension plan

ESG mandates demand more from asset managers

At the outset of their ESG journey, a compelling mission statement was the most critical data point used by pension plans in ESG manager selection. Fund performance and reporting then joined the list. Since the pandemic, however, the list of selection criteria has expanded to permit a clear distinction between qualifiers and differentiators.

Since the pandemic, however, the list of selection criteria has expanded to permit a clear distinction between qualifiers and differentiators.

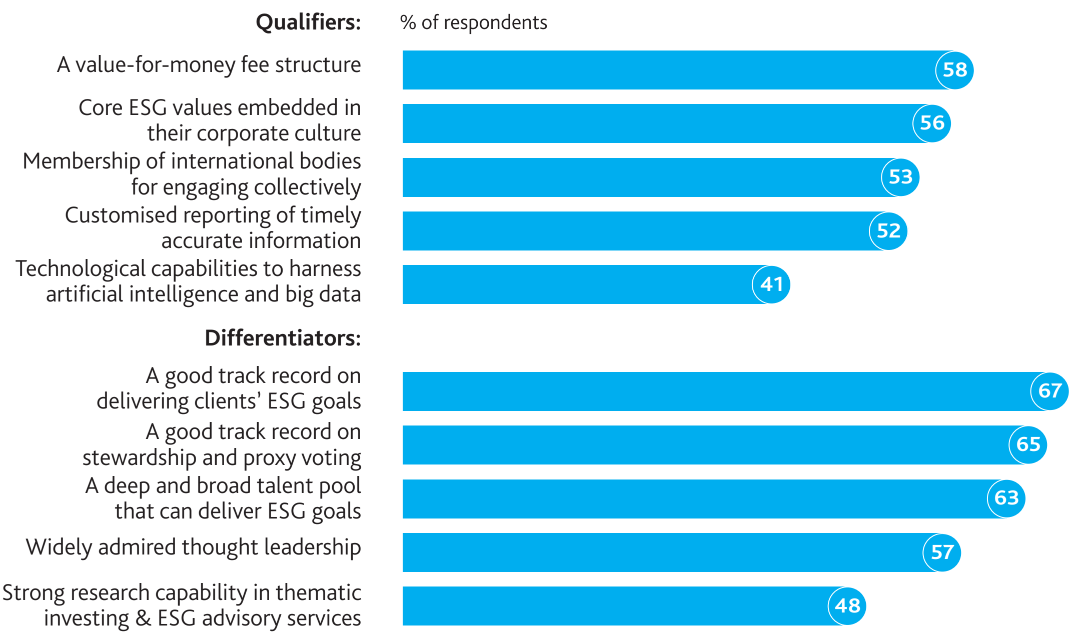
As the name implies, qualifiers are the investment basics that a manager needs to get right to have baseline credibility. Differentiators, on the other hand, are attributes that will give the company a compelling competitive edge over its business rivals in the ESG manager selection process. Both sets of attributes are presented in Figure 4.3.

Among the qualifiers, a value-for-money fee structure tops the list (58%), followed by core ESG values embedded in corporate culture (56%). In the latter context, they want evidence that the values are embedded in key operations, employee incentives and leadership development.

Other qualifiers include membership of international bodies that allows collaborative engagement with investee companies (53%), customised reporting of timely accurate information (52%) and technological capabilities to harness artificial intelligence and big data (41%). These are necessary to secure an ESG mandate, but are by no means sufficient. The differentiators command far more weight. They fall into two clusters.

The first centres on a good track record in delivering clients' ESG goals (67%) and on stewardship and proxy voting (65%). The latter is seen as the single most important instrument for influencing and shaping the ESG agenda of portfolio companies. Until recently, engagement with investee companies followed the traditional principal–agency model, when pension plans and corporate managers in the investee companies sought to pursue their own – often conflicting – goals. The emerging stewardship model, in contrast, seeks to promote a common agenda

Figure 4.3 **What proven attributes do you expect from external asset managers when deciding to give them an ESG mandate?**



Source: Amundi Asset Management / CREATE-Research Survey 2023

Interview quotes

"Effective stewardship is the new frontier of ESG. It requires up to 5% of our investment budget – twice what we have now."

"We expect at least one board director in our portfolio companies to be from discriminated groups like women and ethnic minorities."

Given the qualitative nature of ESG investing, the skills sets required are far more lateral than those needed for traditional investing centred on financial metrics.

based on mutual interest. This progress has been made possible by the EU's Corporate Sustainable Reporting Directive 2022, the 2022 Climate and Investing Reporting in the UK and the new ESG disclosure rules in the US, but for one big difference. In Europe, the emphasis is on shaping ESG strategy and demanding disclosure on progress. In the US, it is on disclosure, without seeming to shape the strategy. In the US, there are also signs of scepticism over so-called 'Say on Climate' votes asking shareholders to approve climate transition strategies.

That said, interest in collaborative engagement on an international scale has not diminished at all – quite the reverse. It gives pension plans enhanced power, legitimacy, urgency and expertise. Indeed, in recognition of its effectiveness, Climate Action 100+ has upped its scrutiny of carbon offsets and CapEx spending on climate action via a new 'disclosure indicator' that tracks two aspects: first, progress on the reduction of a company's emission intensity and comparison with a credible 1.5°C pathway applicable to that sector; and second, CapEx going into converting unabated carbon-intensive assets into greener assets. Indeed, UK regulators are now seeking to improve stewardship via governance and resourcing.

In the second cluster of differentiators, a deep and broad talent pool tops the list (63%). Given the qualitative nature of ESG investing, the skills sets required are far more lateral than those needed for traditional investing centred on financial metrics. Thus, investment professionals are expected to draw on multiple disciplines within modern systems theory that underline the criticality of a multiplicity of factors, the two-way nature of their relationships and their non-linear pathways. The theory also underscores the role of trained insights in data quality as defined by their materiality, validity and reliability.

All these attributes are essential for delivering widely admired thought leadership (57%), proven research capability in thematic investing and ESG advisory services (48%). ESG investing is a major advance on the traditional approach, as revealed by the expanding list of selection criteria.

Interview quotes

"Support for ESG resolutions has fallen this year. But that does not mean we don't hold companies to account on their ESG pledges."

"This year, we did not support the re-election of any of Berkshire Hathaway's board of directors as it failed to make ESG disclosures."

Insights

Canada pushes the standard for collaborative engagement

Climate change tops our stewardship activities. Sadly, what we have lacked so far is a benchmark that can guide our discussions with companies in our portfolio and monitor progress towards our net zero goal.

So, we welcome the recent launch of the Climate Engagement Canada (CEC) Net Zero Benchmark. It helps us assess the impact of our engagement with Canadian companies in hard-to-abate sectors. It also allows issuers to benchmark against their peers inside and outside their sectors. Finally, to put it into the Canadian context, it customises the template that has been tried and tested by Climate Action 100+. The template in question is the upgraded version that sharpens focus on past emission reductions, carbon offsets and CapEx spending; all backed by a novel 'disclosure indicator'.

This evaluates whether a company's carbon emissions have decreased year-on-year or over three years and compares them against credible 1.5°C sector-relevant pathways. The benchmark has started scoring companies on its target list and the results will be published soon. The overall aim is to promote a just transition to a net zero world for an economy heavily dependent on fossil fuels.

The initiative was designed in collaboration with the Canadian government, helping to converge towards universal standards, as advocated by the UN PRI. Collaborative working with like-minded peers, nationally and internationally, is essential to overcome potential litigation against trade collusion under the prevailing anti-competition laws.

A Canadian pension plan

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- *Active investing: Shaping its future in a disruptive environment (2017)*
- *Digitisation of asset and wealth management (2017)*

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Amundi Asset Management

Amundi, the leading European asset manager, ranking among the top 10 global players[1], offers its 100 million clients – retail, institutional and corporate – a complete range of savings and investment solutions in active and passive management, in traditional or real assets. This offering is enhanced with IT tools and services to cover the entire savings value chain. A subsidiary of the Crédit Agricole group and listed on the stock exchange, Amundi currently manages more than €1.95 trillion of assets[2].

With its six international investment hubs[3], financial and extra-financial research capabilities and long-standing commitment to responsible investment, Amundi is a key player in the asset management landscape.

Amundi clients benefit from the expertise and advice of 5,400 employees in 35 countries.

Amundi, a trusted partner, working every day in the interest of its clients and society.

www.amundi.com

[1] Source: IPE "Top 500 Asset Managers" published in June 2023, based on assets under management as at 31/12/2022

[2] Amundi data as at 30/09/2023

[3] Boston, Dublin, London, Milan, Paris and Tokyo

Amundi Investment Institute

In an increasingly complex and changing world, investors have expressed a critical need to better understand their environment and the evolution of investment practices in order to define their asset allocation and help construct their portfolios. Situated at the heart of the global investment process, the Amundi Investment Institute's objective is to provide thought leadership, strengthen the advice, training and daily dialogue on these subjects across all assets for all its clients – distributors, institutions and corporates. The Amundi Investment Institute brings together Amundi's research, market strategy, investment insights and asset allocation advisory activities. Its aim is to project the views and investment recommendations of Amundi.

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CREATE-Research

CREATE-Research is an independent research boutique specialising in strategic change and the newly emerging business models in global asset management. It undertakes major research assignments from prominent financial institutions and global companies. It works closely with senior decision makers in reputable organisations across Europe and North America.

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IMPORTANT INFORMATION

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